

*Note: Tax Guidelines explain the Malta Inland Revenue's interpretation of legislation and the way the Department applies the law in practice. They do not affect a taxpayer's right to argue for a different interpretation, if necessary in an appeal to the Board of Special Commissioners or the Court of Appeal.*

# Bad Debts

## **1. Purpose of this Guideline**

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This Guideline clarifies the circumstances in which a deduction for bad debts will be allowable. It applies to bad debts in respect of which a claim is made for the year of assessment 2003 and subsequent years of assessment.

## **2. Sub-article 14(1)(d) of the Income Tax Act**

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Sub-article 14(1) of the Income Tax Act lists "outgoings and expenses" which may be deducted for the purpose of ascertaining the total income of any person, to the extent to which they are wholly and exclusively incurred in the production of the income. These include, under paragraph (d):

"bad debts incurred in any trade, business, profession or vocation, proved to the satisfaction of the Commissioner to have become bad during the year immediately preceding the year of assessment notwithstanding that such bad debts were due and payable prior to the commencement of the said year:

Provided that all sums recovered during the said year on account of amounts previously written off or allowed in respect of bad debts shall for the purpose of this Act be treated as receipts of the trade, business, profession or vocation for that year".

## **3. Conditions**

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The conditions to be satisfied in order to qualify for a bad debt deduction are therefore six. First, a debt must have been created in favour of claimant. Second, the debt must have arisen in a trade, business, profession or vocation. Third, it must have become bad. Fourth, the debt must have become bad during the year in respect of which the deduction is claimed. Fifth, this has to be proved to the satisfaction of the Commissioner. Sixth, the debt must have been brought to account as assessable income in a previous year.

## **4. What constitutes a debt**

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A debt is a sum of money due from one person to another. Where a taxpayer is entitled to receive a sum of money from another, it is accepted that a debt exists for the purpose of this guideline.

## **5. When a debt becomes bad for sub-article 14(1)(d)**

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According to sub-article 14(1)(d) the Commissioner has to be satisfied that the debt has become bad. Whether a debt is bad depends upon an objective consideration of all the relevant circumstances of each case. According to previous Revenue practice, a debt is not considered to have become "bad" until:

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

- (d) the debt has become statute-barred; or
- (e) (in the case of a corporate debtor) the debtor is liquidated or is in liquidation and there are insufficient funds to pay the whole debt, or the part claimed as bad debt; or
- (f) the creditor has taken all the legally available steps to recover the debt, where appropriate; or
- (g) the debtor has absconded and his whereabouts are not known.

## **6. Bad, not in the strict sense**

The proviso to sub-article 14(1)(d) contemplates that a sum may subsequently be recovered in respect of a debt previously written off as bad. This in itself shows that the debt need not be bad in the strict sense as outlined in paragraph 5 above for an allowance to be due. The Commissioner is hereby setting out the circumstances where the debt need not necessarily be "bad" in the strict sense and is still allowed. As long as the commercial judgement pointing to the relevant fact indicates that a debt is bad for the time being, the debt is accepted as bad for tax purposes. It is not essential that a creditor take all legally available steps to recover the debt. What is necessary is that the creditor makes a *bona fide* assessment, based on sound commercial consideration, of the extent to which the debt is bad.

Although the debt need not be bad in the strict sense as set out above (categories (a) to (g) in number 5 above), it must nonetheless be more than merely doubtful. A debt will not be accepted as bad merely because the period of time usually set for payment has elapsed with no payment or contact having been made by the debtor.

Apart from the circumstances mentioned in paragraph 5 above, the Commissioner has ruled that a debt may be considered to have become bad also in circumstance (h), that is, *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 part of the debt, being recovered.*

A debt will be accepted as bad under category (h) above where a taxpayer has taken the appropriate steps in an attempt to recover the debt and not simply written it off as bad. Such steps would include some or all of the following, *depending upon the amount involved and the resources available to the creditor to pursue the debt:*

- i. reminder notices issued and telephone/mail contact is attempted;
- ii. a reasonable period of time has elapsed since the original due date for payment of the debt (this will vary depending upon the amount of the debt outstanding and the taxpayer's credit arrangements);
- iii. a formal demand notice is served;
- iv. issue of, and service of, a summons;
- v. a judgment has been entered against the delinquent debtor;
- vi. execution proceedings have been instituted to enforce judgement;
- vii. the calculation and charging of interest is ceased and the account is closed;
- viii. a valuation has been made of any security held against the debt;
- ix. sale of any seized or repossessed assets.

The above factors are indicative of the circumstances in which a debt may be considered bad. However, 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. *It must however be borne in mind that the taxpayer is responsible for establishing that a debt is bad and bears the onus of proof in this regard.*

## **7. Other circumstances where debt may be considered bad**

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Although not satisfying the conditions set out in paragraphs 5 and 6 above, a debt may still be considered to have become bad where:

- (a) the period of time which has elapsed since the original due date for payment of the debt exceeds twenty four months; and
- (b) the debt is equivalent to an amount not exceeding Lm500; and
- (c) the total bad debts figure being written off during any year of assessment does not exceed 2% of the turnover of the taxpayer in the year of assessment in which the debt is written off; and
- (d) *prima facie* proof is provided that taxpayer has taken adequate steps in an attempt to recover the debt or a portion of the debt (e.g. *ittra bl-avukat*).

This paragraph applies to debts with an original date for payment falling due on or after 1 January, 2002.

## **8. No additional tax imposed**

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If, during an enquiry, instituted under article 31 of the Income Tax Management Act, it is established that a debt, previously considered by the taxpayer to have become bad, was not actually bad or was not incurred in the year claimed by the taxpayer, and it is proved that the taxpayer had taken the appropriate steps mentioned in paragraphs 5, 6 and 7 above, in an attempt to recover the debt, then the taxpayer shall not be considered to have made an omission from his return.

It is only where a taxpayer has written off a debt as bad without following this guideline and the Commissioner has issued an assessment with respect to such debt that the additional tax for omission will be applied.

## **9. No deduction for bad debt provisions or reserves**

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It is not enough to simply make a provision for a bad debt. The Income Tax Act does not contemplate a deduction for bad debt provisions. The bad debt is to have been incurred and written off and not merely provided for.

## **10. Written proof**

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Such writing off does not necessitate any particular form of book entry. It is sufficient if there are written particulars indicating that the creditor has treated the debt as bad.

However, the Commissioner reserves the right to request statements from the taxpayer setting out details as to names of debtors, amounts, dates etc in respect of which debts or portions of debts have been written off. [Appendix 1 shows a specimen statement on the lines of which one is expected to keep in respect of debts considered to have become bad and of debts which, although previously considered bad, are recovered.]

Where the total amount of bad debts in any one year exceeds Lm2,000, a taxpayer must attach to his income tax return for that year a list of the debtors and the amount involved in respect of each debtor.

## **11. Bad debt in same year**

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The Commissioner has ruled that where a debt becomes bad during the same year in which it would have been brought to account as assessable income, then such debt may still be claimed as an expense, provided that:

- (a) the amount written off is *brought to account as assessable income* amongst the sales/receipts/takings for the year; and

(b) the debt is *bad in the strict sense* (i.e. in one of the circumstances listed in paragraph 5).

## **12. The debt must have been brought to account as assessable income**

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The requirement of sub-article 14(1)(d) that the debt is to have been "due and payable prior to the commencement of the said year" presupposes an accruals basis of accounting for tax purposes. A taxpayer who operates on a cash receipts basis is not entitled to a deduction for bad debts. In such case the outstanding amount has not been included as part of the taxpayer's income and, therefore, has never been included in the assessable income of that taxpayer.

## **13. In the production of the income, in trade**

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For a bad debt to be an allowable deduction it must have been incurred "in the production of the income" and "in any trade, business, profession or vocation". The expense must not be of a capital, private or domestic nature. In other words, the debt is to have been incurred in connection with circulating capital. No deduction is allowed for capital loans or advances which are not repaid – unless of course the creditor is a money-lender, an integral part of whose business operations is the making of loans. Other instances where a deduction is not allowed include: a loss in the value of an investment; unrecoverable interest receivable (except where the creditor is a money-lender); unrecoverable rent receivable (except where the creditor's trade consists in rental income).

## **14. Where debt is recovered**

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The proviso to sub-article 14(1)(d) provides that 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.

A recovery of a bad debt is to be declared and shown in the accounts accompanying the tax return. A taxpayer who, having claimed a bad debt without having taken any appropriate action under paragraphs 5 to 7, wishes to rectify such default, may not do so by reversing the figure in a return for a subsequent year, giving it the semblance of a recovery of a bad debt. To rectify such an error in his self-assessment, such person has to file an Adjustment Form (AF1); the default attracts additional tax for omission at 0.75% per month (if rectification is made before an enquiry is started).

**LIST OF BAD DEBTS WRITTEN OFF**

Details of Transaction					Details of Debtor		
Transaction Number	Date when debt was written off	Year when amount was charged to tax	Relevant Invoice Number	Amount of Bad Debt written off	IT Reference/ID Number	Name	Address
1							
2							
3							
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6							
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**LIST OF PREVIOUSLY WRITTEN OFF BAD DEBTS SUBSEQUENTLY RECOVERED**

Details of Transaction					Details of Debtor		
Transaction Number	Tranaction Number when Debt was written off	Amount of Debt Recovered	Date when received	Receipt Number	ID Number	Name	Address
1							
2							
3							
4							
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