IMPLEMENTING SECTION 34(E) OF THE TAX CODE OF 1997 ON THE REQUIREMENTS FOR DEDUCTIBILITY OF BAD DEBTS FROM GROSS INCOME

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SECTION 1. Scope. — Pursuant to the provisions of Section 244 of the Tax Code of 1997, these regulations are hereby promulgated to implement the provisions of Section 34(E) of the same Code on the requirements for deductibility of bad debts from the gross income of a corporation or an individual engaged in trade or business or a professional engaged in the practice of his profession.

SECTION 2. Definition of Terms. — For purposes of these regulations, the following words and phrases shall have the following meaning, viz:

- "Bad debts" — shall refer to those debts resulting from the worthlessness or uncollectibility, in whole or in part, of amounts due the taxpayer by others, arising from money lent or from uncollectible amounts of income from goods sold or services rendered.

- "Securities" — shall mean shares of stock in a corporation and rights to subscribe for or to receive such shares. The term includes bonds, debentures, notes or certificates, or other evidence of indebtedness, issued by any corporation, including those issued by a government or political subdivision thereof, with interest coupons or in registered form.

- "Actually ascertained to be worthless" — In general, a debt is not worthless simply because it is of doubtful value or difficult to collect. Worthlessness is not determined by an inflexible formula or slide rule calculation but upon the exercise of sound business judgment. The determination of worthlessness in a given case must depend upon the particular facts and the circumstances of the case. A taxpayer may not postpone a bad debt deduction on the basis of a mere hope of ultimate collection or because of a continuance of attempts to collect notes which have long become overdue, and where there is no showing that the surrounding circumstances differ from those relating to other notes which were charged off in a prior year. While a mere hope probably will not justify postponement of the deduction, a reasonable possibility of recovery will permit the account to be carried along notwithstanding that the probabilities are that the debt may not be collected at all. The creditor may offer evidence to show some expectation that the debt would have been paid in the intervening years, and that subsequently, the hope was shattered or appeared to have been unfounded. If, for example, the creditor could show that during the years he attempted to collect the debt, the debtor had property the title of which was in dispute but which would enable him to pay his debts when the title was cleared, the creditor would be entitled to defer the deduction on the ground that there was no genuine ascertainment of worthlessness.

Thus, accounts receivable, the amount whereof is insignificant and the collection of which through court action may be more costly to the taxpayer, may be written-off as bad debts even without conclusive evidence that the taxpayer's receivable from a debtor has definitely become worthless.

Good faith does not require that the taxpayer be an "incorrigible optimist" but on the other hand, he may not be unduly pessimistic. Creditors do not have to wait until some turn of the wheel of fortune may bring their debtors

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into affluence. The taxpayer may strike a middle course between pessimism and optimism and determine debts to be worthless in the exercise of sound business judgment based upon as complete information as is reasonably ascertainable. The taxpayer need not have perfect discernment.

- "Actually charged off from the taxpayers books of accounts" — This phrase means that the amount of money lent by the taxpayer (in the course of his business, trade or profession) to his debtor had been recorded in his books of account as a receivable has actually become worthless as of the end of the taxable year, that the said receivable has been cancelled and written-off from the said taxpayer's books of account. A mere recording in the taxpayer's books of account of estimated uncollectible accounts does not constitute a write-off of the said receivable, hence, shall not be a valid basis for its deduction as a bad debt expense. In no case may any bad debt deduction be allowed unless the facts pertaining to the money or property lent and its cancellation or write-off from the taxpayer's accounting records, after having been determined that the same has actually become worthless, have been complied with by the taxpayer.

SECTION 3. Requisites for Valid Deduction of Bad Debts From Gross income. — General Rule. — In general, the requisites for deductibility of bad debts are:

- There must be an existing indebtedness due to the taxpayer which must be valid and legally demandable;

- The same must be connected with the taxpayer's trade, business or practice of profession;

- The same must not be sustained in a transaction entered into between related parties enumerated under Sec. 36(B) of the Tax Code of 1997;

- The same must be actually charged off the books of accounts of the taxpayer as of the end of the taxable year; and

- The same must be actually ascertained to be worthless and uncollectible as of the end of the taxable year.

Before a taxpayer may charge off and deduct a debt, he must ascertain and be able to demonstrate with reasonable degree of certainty the uncollectibility of the debt. The Commissioner of Internal Revenue will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor in determining whether a debt is worthless, or the assigning of the case for collection to an independent collection lawyer who is not under the employ of the taxpayer and who shall report on the legal obstacle and the virtual impossibility of collecting the same from the debtor and who shall issue a statement under oath showing the propriety of the deductions thereon made for alleged bad debts. Thus, where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of those facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction.

Exception: In the case of banks, however, in lieu of requisite No. 5 above, the Bangko Sentral ng Pilipinas (BSP), thru its Monetary Board, shall ascertain the worthlessness and uncollectibility of the bad debts and it shall approve the writing off of the said indebtedness from the banks' books of accounts at the end of the taxable year. The bank though should still comply with requisites Nos. 1-4 as enumerated above before it can avail of the benefit of deduction.

Also, in no case may a receivable from an insurance or surety company be written-off from the taxpayer's books and claimed as bad debts deduction unless such company has been declared closed due to insolvency or for any such similar reason by the Insurance Commissioner.

SECTION 4. Tax Benefit Rule. — The recovery of bad debts previously allowed as deduction in the preceding

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year or years shall be included as part of the taxpayer's gross income in the year of such recovery to the extent of the income tax benefit of said deduction. Example: If in the year the taxpayer claimed deduction of bad debts written-off, he realized a reduction of the income tax due from him on account of the said deduction, his subsequent recovery thereof from his debtor shall be treated as a receipt of realized taxable income. Conversely, if the said taxpayer did not benefit from the deduction of the said bad debt written-off because it did not result to any reduction of his income tax in the year of such deduction (i.e. where the result of his business operation was a net loss even without deduction of the bad debts written-off), then his subsequent recovery thereof shall be treated as a mere recovery or a return of capital, hence, not treated as receipt of realized taxable income.

SECTION 5. Securities Becoming Worthless. — If securities, as defined under Sec. 2(b) hereof, held as capital asset, are ascertained to be worthless and charged off within the taxable year, the loss resulting therefrom shall be considered as a loss from the sale or exchange of capital asset made on the last day of such taxable year. The taxpayer, however, has to prove through clear and convincing evidence that the securities are in fact worthless.

This rule, however, is not true in the case of banks or trust companies incorporated under the laws of the Philippines, a substantial part of whose business is the receipt of deposits.

SECTION 6. Repealing Clause. — The provision of any revenue regulations, revenue memorandum order, revenue memorandum circular or any other revenue issuances inconsistent with these Regulations are hereby repealed, amended, or modified accordingly.

SECTION 7. Effectivity Clause. —These Regulations shall take effect fifteen (15) days after publication in any newspaper of general circulation.

Adopted: 10 March 1999

(SGD.) EDGARDO B. ESPIRITU
Secretary of Finance

RECOMMENDING APPROVAL:

(SGD.)BEETHOVEN L. RUALO
Commissioner of Internal Revenue

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