

DRAFT INTERPRETATION NOTE

DATE:

ACT : INCOME TAX ACT 58 OF 1962
SECTION : SECTION 11(j)
SUBJECT : DOUBTFUL DEBTS

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Preamble

In this Note unless the context indicates otherwise –

- “**doubtful debt allowance**” means the allowance calculated under section 11(j) of the Act;
- “**ECL**” means expected credit loss;
- “**IAS**” means International Accounting Standards;
- “**IFRS**” means International Financial Reporting Standards;
- “**LECL**” means lifetime expected credit loss;
- “**PD**” means probability of default;
- “**RFI**” means Request for Information;
- “**section**” means a section of the Act;
- “**the Act**” means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

All forms and templates referred to in this Note are available on the SARS website at www.sars.gov.za. Unless indicated otherwise, the latest issues of these documents should be consulted.

1. Purpose

This Note provides guidance on calculating the section 11(j) doubtful debt allowance.

2. Background

Section 11(j) provides an allowance to taxpayers for debts that are due but are considered to be doubtful. Under the previous wording of section 11(j), this section applied to all taxpayers with the Commissioner having the discretion to determine the amount of the debt that was considered doubtful. In practice, SARS generally allowed 25% of a taxpayer’s listed doubtful debts as doubtful debt allowance. Taxpayers could

apply to SARS for an increased doubtful debt allowance based on their specific facts and circumstances. Owing to the ongoing process to prepare for an income tax self-assessment system¹ and IFRS 9² coming into effect, section 11(jA)³ was introduced and section 11(j) was subsequently amended. Under the amended section 11(j), the calculation of the allowance that taxpayers (excluding those taxpayers to which section 11(jA) applies)⁴ may claim in respect of doubtful debts depends on whether the taxpayer applies IFRS 9 to the debt for financial reporting purposes⁵ or whether IFRS are not applied to the debt for financial reporting purposes.⁶

The proviso to section 11(j)(i) and (ii) gives the Commissioner the discretion to approve an increase to some of the percentages specified in section 11(j) that are used in calculating the doubtful debt allowance to a percentage not exceeding 85%.

A detailed discussion of the workings of IFRS 9 exceeds the scope of this document. It is, however, necessary to provide some discussion and context as IFRS 9 is referenced in section 11(j)(i) for purposes of determining the doubtful debt allowance for a taxpayer that applies IFRS 9 to the debt for financial reporting purposes.

Before the introduction of IFRS 9, doubtful debt provisioning for financial reporting purposes was based on IAS 39. IAS 39 models relied on past observations with the further requirement of estimating future recoveries. Following the global collapse of financial institutions, the International Accounting Standards Board set out to correct the perceived weakness of delayed recognition of credit losses on loans and other financial instruments. The International Accounting Standards Board introduced IFRS 9 replacing IAS 39. While IAS 39 was based on an incurred loss model, IFRS 9 introduced a forward-looking “expected loss” model, which includes the incorporation of forward-looking information in the recognition of impairments on debts considered doubtful.

3. IFRS terminology

Section 11(j)(i) contains certain terminology derived directly from IFRS. The legislation accordingly cannot be understood in isolation from IFRS. For this reason some of the pertinent IFRS terminology is discussed below.⁷

3.1 Expected credit loss

An ECL is the probability-weighted result of the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive (that is, all cash shortfalls) discounted at the original effective interest rate.

¹ Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018.

² IFRS 9 replaced IAS 39, Financial Instruments – Recognition and Measurement.

³ Doubtful debt allowance in respect of specified debt for certain taxpayers falling within the definition of “covered persons” in section 24JB(1).

⁴ Section 11(jA) applies to certain taxpayers falling within the definition of “covered persons” in section 24JB(1).

⁵ Section 11(j)(i).

⁶ Section 11(j)(ii).

⁷ The definitions have been adapted from IFRS 9 Appendix A – Defined Terms.

3.2 Lifetime expected credit loss

An LECL is the expected credit loss that results from all possible default events over the expected life of the debt. This is the expected present value of losses that may arise when borrowers default on their obligation to make a repayment at some time over the life of the debt.

3.3 Loss allowance

The loss allowance is the provision for expected credit losses.

3.4 Impairment

A debt is considered credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that debt have occurred. These are referred to as default events. Evidence that a borrower is experiencing financial difficulty or that a debt is credit-impaired includes, but is not limited to, a breach of contract in terms of repayment, the probability of the borrower entering bankruptcy or other observable data relating to the recovery of the debt. It is not always possible to identify a single discrete event for impairment and it may be necessary to take the combined effect of several events into account.

IFRS 9 recognises various stages at which the ECLs must be recognised. The stage depends on the level of risk at the inception of the debt compared with the current level of risk associated with the repayment of the debt. Debts generally move through the various stages where there is a significant increase in the level of credit risk as evidenced through missed payments or other observable factors. In other words, the higher the risk of non- or late payment, the higher the stage of impairment. A debt is generally considered as being in default once it reaches stage 3. This stage involves the highest level of risk of non- or late payment of the debt.

The stage of default also determines how interest revenue is accounted for in the financial statements.

Different entities regard the point at which a debt is in default differently. IFRS 9 requires an entity to apply a definition of default that is consistent with how it is defined for its normal credit risk management practices, consistently from one period to another. It therefore follows that an entity might have to use different default definitions for different types of debt. IFRS 9 also requires that an entity needs to consider qualitative factors in addition to quantitative factors.

The different stages are described below.

3.4.1 Stage 1: 12-month expected credit losses

Twelve-month ECLs are the expected credit losses that arise from default events that may occur within 12 months after the reporting date (or a shorter period if the expected life of the debt is less than 12 months). It is calculated as the expected credit loss that will arise in the event of default, weighted by the PD occurring. The PD is simply the likelihood of a debtor defaulting on his or her obligations over a particular time period. The lower the PD, the less likely the debtor will default and consequently the lower the provision. The standard requires that these ECLs are recognised as soon as the debt is advanced or purchased, that is, this provision is raised on day 1 before any observable events of default may occur.

3.4.2 Stage 2: Lifetime expected credit loss

As noted in **3.2**, the LECL is the expected present value of losses that may arise in the event that borrowers default on their obligation to make a repayment at some time over the life of the debt. If there has been a significant increase in credit risk since original recognition but the debt has not been impaired (as discussed above), it is classified as Stage 2 and an LECL is recognised for financial reporting purposes.

3.4.3 Stage 3: Lifetime expected credit loss

Debt which is considered for all material purposes as irrecoverable but which has not yet been written off, will be reflected in the financial statements as Stage 3 (credit impaired) exposures. This could include debt that is either already in default or when default is imminent.

IFRS 9 requires an entity to write off non-performing debt only when there is no reasonable expectation of further material recoveries.

3.5 The model

Under the IFRS 9 framework, an entity is required to develop models to estimate their ECLs. The model enables the user to trace debts through the stages from initial recognition until their final maturity. The model is a forward-looking “expected loss” impairment model, which requires entities to consider each and every debt on its balance sheet, regardless of the debt’s age and whether or not it contains a portion of overdue debt at that point in time.

3.6 Forward looking information

When estimating ECLs using the model referred to in **3.5**, management should consider information that is reasonably available, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions. IFRS 9 requires management to forecast the credit losses that the entity is expected to incur because of defaults under different scenarios covering prescribed future periods. Forward-looking macro-economic information must be incorporated into expected loss estimates through the application of quantitative modelling and expert-judgement-based adjustments. ECLs should be calculated for the core (best estimate) scenario, an upside scenario and a downside scenario. The probability-weighted average of the ECL figures calculated under each of these scenarios should result in the calculation of ECL estimates which are unbiased.

3.7 Partial write-off

IFRS 9 states that an entity must write off debt when the entity has no reasonable expectation of recovering the debt in its entirety or a portion thereof. This introduced the option of partial write-offs.

4. The law

Section 11(j)

11. General deductions allowed in determination of taxable income.—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—

- (j) an allowance in respect of any debt due to the taxpayer, if that debt would have been allowed as a deduction under any other provision of this Part had that debt become bad, of an amount equal to—
 - (i) if IFRS 9 is applied to that debt by that person for financial reporting purposes, the sum of—
 - (aa) 40 per cent of the aggregate of—
 - (A) 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 as defined in IFRS 9; and
 - (B) the amounts of debts disclosed as bad debt 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; and
 - (bb) 25 per cent 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 under item (aa); or
 - (ii) if IFRS is not applied to that debt by that person for financial reporting purposes, the sum of—
 - (aa) 40 per cent of so much of any debt, other than a debt contemplated in subparagraph (i), due to the taxpayer, if that debt is 120 days or more in arrears; and
 - (bb) 25 per cent of so much of any debt, other than a debt contemplated in subparagraph (i) or item (aa), due to the taxpayer, if that debt is 60 days or more in arrears:

Provided that an allowance under this paragraph must be included in the income of the taxpayer in the following year of assessment: Provided further that the Commissioner may, on application by a taxpayer, issue a directive that the percentage contemplated in subparagraph (i)(aa) or (ii)(aa) may be increased, to a percentage not exceeding 85 per cent after taking into account—

- (A) the history of a debt owed to that taxpayer, including the number of repayments not met, and the duration of the debt;
- (B) steps taken to enforce repayment of the debt;
- (C) the likelihood of the debt being recovered;
- (D) any security available in respect of that debt;
- (E) the criteria applied by the taxpayer in classifying debt as bad; and
- (F) such other considerations as the Commissioner may deem relevant;

5. Application of the law

5.1 Introduction

Section 11(j) makes provision for an annual doubtful debt allowance for taxpayers *other* than those taxpayers to which the provisions of section 11(jA) apply.⁸ The determination of whether a debt qualifies for doubtful debt allowance must be made at the end of the taxpayer's year of assessment.

In order for a deduction to be granted under section 11(j), it must have been possible for the debt in question to have been deductible under another section of the Act had it become bad.

Moreover, the allowance granted in a particular year of assessment must be included in the taxpayer's income in the following year of assessment.

5.2 Structure and workings of section 11(j)

Section 11(j) comprises two main subparagraphs, namely, subparagraph (i) which applies to taxpayers who apply IFRS 9 to their debt due for financial reporting purposes (see 5.3 and 5.4), and subparagraph (ii), which applies to taxpayers who do not apply IFRS to their debt for financial reporting purposes (see 5.5).

Subparagraphs (i) and (ii) both provide taxpayers with doubtful debt tax allowances calculated using a combination of rates of 40% or 25% depending on the facts of the particular case. Also dependent on the facts of the case, the proviso to subparagraph (i) and (ii) allows taxpayers to apply to SARS for a directive permitting the doubtful debt allowance of 40% to be increased to a higher rate not exceeding 85% (see 5.6).

Although subparagraphs (i) and (ii) both apply 40% and 25% in calculating the doubtful debt allowance, the base to which those percentages are applied is different under the two subparagraphs (see 5.3 and 5.5).

5.3 Allowance applicable when IFRS 9 is applied by a taxpayer to the debt for financial reporting purposes [section 11(j)(i)]

As noted above, taxpayers claiming doubtful debt allowances under section 11(j)(i) do so if they apply IFRS 9 to the debt for financial reporting purposes. These taxpayers can claim doubtful debt allowances at 40% and 25% of the specified base, which is dependent on the category of the debt and its IFRS treatment in respect of the calculation of loss allowances relating to impairment and certain bad debt write-offs (see below for more detail).

Taxpayers are entitled to a doubtful debt allowance of 40% of the aggregate of –

- the loss allowance relating to impairment which is equal to the lifetime expected credit loss, as contemplated in IFRS 9, in respect of debt due other than "lease receivables" as defined in IFRS 9;⁹ and

⁸ Section 11(jA) applies to certain taxpayers included in the definition of covered persons in section 24JB(1).

⁹ This allowance would generally apply to the Stage 2 and Stage 3 LECL provisions raised by a taxpayer under IFRS 9 (see 3.4.2 and 3.4.3).

- the amount of debts that have been disclosed as bad debts written off for financial reporting purposes that have not been allowed as a deduction under section 11(j)¹⁰ in the current or any previous year of assessment and which debt is included in the taxpayer's income in the current or any previous year of assessment.

Taxpayers are also entitled to a doubtful debt allowance of 25% of the IRFS9 loss allowance relating to impairment, in respect of other debts, that is, debts excluding lease receivables or any debt already included as part of the 40% allowance. This allowance would generally apply to debts in the Stage 1: 12-month ECL stage of default (see 3.4.1).

No doubtful debt allowance will be granted in respect of lease receivables. As indicated under 3.6 IFRS 9 allows for debt to be partially written off for financial reporting purposes. Such debt that has been partially written off for financial reporting purposes will generally not be deductible as it is not yet considered bad for tax purposes and should be included in the debt to which the provisions to section 11(j) apply.

The deduction granted in a year of assessment must be included in the income of the taxpayer in the following year of assessment.

The doubtful debt allowance is granted in respect of debt due to a taxpayer. Where there is an unused facility, for example retail accounts with an available limit which has not been fully used, or credit cards and overdrafts with undrawn amounts, the portion of the loss allowance as calculated under IFRS 9 relating to the used facility does not qualify for a doubtful debt allowance.

Example 1 – Deduction when IFRS 9 is applied

Facts:

FinCo's year of assessment ends on 31 December. FinCo's business comprises a mix of trade debt as well as other credit advanced to its customers.

At the end of the 2019 year of assessment, FinCo's IFRS 9 loss allowance relating to impairment was R800 000, which was equal to its LECL. FinCo's bad debt, which was written off for financial reporting purposes but not allowed as a deduction under section 11(j), was R400 000. The debt written off had been included in income in a previous year of assessment.

The amount of the IFRS 9 loss allowance relating to other debts, which was measured on a basis other than LECL for IFRS 9 purposes, was R350 000.

Amounts relating to lease receivables were excluded from the debt figures used in calculating the loss allowances referred to above.

All of the debts would have qualified for a deduction under the Act if they were considered bad for tax purposes.

¹⁰ Under section 11(j), a deduction may be allowed on the amount of any debt due to the taxpayer which has, during the year of assessment, become bad.

<i>Result:</i>	
Section 11(j)(i)(aa)	R
Loss allowance relating to impairment ¹¹	800 000
Bad debts written off for financial reporting purposes but not deducted under section 11(j) ¹²	<u>400 000</u>
Aggregate amount	<u>1 200 000</u>
40% × R1 200 000	480 000
Section 11(j)(i)(bb)	
25% × R350 000	87 500
The deduction available to FinCo under section 11(j)(i) for the 2019 year of assessment is R567 500 (R480 000 + R87 500). This amount must be included in FinCo's income in the subsequent year of assessment.	

5.4 Application procedure for an increased allowance rate directive for section 11(j)(i)

Taxpayers applying IFRS 9 to their debt for financial reporting purposes may, under the proviso to section 11(j), request a directive from SARS for an increased percentage for those debts to which the 40% doubtful debt allowance applies. The rate may be increased to a maximum of 85%. The application for an increased allowance must include the information listed in 5.6. The format in which the information needs to be provided to SARS has been set out in an RFI as well as excel-based templates that need to be completed.

As stated in 3.4, the allowance relating to impairment that is measured at an amount equal to the LECL, as contemplated in IFRS 9 and falling under section 11(j)(i)(aa)(A), includes both IFRS Stages 2 and 3. Stage 2 debts are those debts that are not yet in default and will generally not qualify for an increased percentage allowance. Debts that are reflected as Stage 3 are those debts for which the entity has objective evidence of impairment. In considering the application for an increased percentage where a debtor is not in default (Stage 2 debts) an allowance above 40% will only be considered in exceptional circumstances. Notwithstanding the fact that these debts may be considered to be in default, the application for a directive is a requirement to be entitled to claim an increased percentage allowance. If no application for a directive is made these debts will remain subject to the 40% allowance.

¹¹ Section 11(j)(i)(aa)(A).

¹² Section 11(j)(i)(aa)(B).

5.4.1 Calculation of the increased percentage under the proviso

Both Stage 2 and Stage 3 debts will be included in the debt to which the default 40% doubtful debt allowance applies. As stated above, SARS is of the view, however, that where a debt is not in default or where default is not imminent, an allowance above 40% can only be justified in extreme circumstances. It may therefore be necessary to calculate a weighted average rate that will depend on the blend of Stage 2 and Stage 3 debts. SARS will apply the following formula in determining the increased rate to be allowed in terms of any directive to be issued:

$$X = (Y + Z) / (A + B)$$

X = Effective percentage to be applied for purposes of section 11(j)(i)

$$Y = 40\% \times A$$

$$Z = 85\% \times B$$

A = LECL in respect of debtors not in default (Stage 2)

B = LECL in respect of debtors in default (Stage 3)

The effective rate calculated is not fixed and as the distribution of a taxpayer's debt book changes, the effective rate will change accordingly.

5.5 Application procedure for an increased allowance rate directive for section 11(j)(ii)

Section 11(j)(ii) provides non-IFRS reporting taxpayers allowances on debt that is overdue, at a rate of 40% or 25% if the detailed requirements of the section are met. If the debt is in arrears for 60 days or more, the taxpayer can claim a doubtful debt allowance in respect of such debt at a rate of 25%. If the debt is in arrears for 120 days or more, the taxpayer can claim a doubtful debt allowance of 40% in respect of such debt.

In common with section 11(j)(i), is the proviso which allows taxpayers to request a directive from SARS for an increased doubtful debt allowance percentage not exceeding 85% if the debt is 120 days or more in arrears. Taxpayers applying for a directive can obtain an increased percentage allowance of up to 85%. The decision of where a debt will fall within this range is at the Commissioner's discretion. In determining the quantum of the percentage the Commissioner will allow, a taxpayer will be required to provide the information specified in subitems (A) to (F) (see 5.6) of the proviso to section 11(j). The format in which the information needs to be provided to SARS has been set out in an RFI, and needs to be accompanied by the excel-based templates that have been developed for this purpose.

A taxpayer that does not apply IFRS to the debt or financial reporting purposes, may deduct –

- 40% of the debt [excluding debt contemplated in section 11(j)(i)] that is in arrears for 120 days or more; plus
- 25% of the debt (excluding debt contemplated in section 11(j)(i) or the preceding bullet point) that is in arrears for 60 days or more.

The amount that is allowed as a deduction must be included in the taxpayer's income in the following year of assessment.

Example 2 – Deduction when IFRS 9 is not applied

Facts:

Frequent Lender's year of assessment ends on 31 December. Frequent Lender did not apply IFRS to its debts for financial reporting purposes.

According to Frequent Lender's list of doubtful debts at the end of the 2019 year of assessment, the following were reflected:

	R
Debts in arrears for 120 days or more	900 000
Debts in arrears for 60 days but less than 120 days	500 000
Debts in arrears for less than 60 days	300 000

All of the debts would have qualified for a deduction under the Act if they were considered bad for tax purposes.

Result:

Under section 11(j)(ii), the deduction available to Frequent Lender was:

40% × R900 000	360 000
25% × R500 000	<u>125 000</u>
Deduction available for the 2019 year of assessment	<u>485 000</u>

The deductible amount must be included in Frequent Lender's income in the following year of assessment.

A taxpayer may apply for a directive to increase the 40% allowance to an amount not exceeding 85%. The Commissioner's discretion will only be exercised in respect of debts that are more than 120 days in arrears.

Taxpayers wishing to claim the increased percentage under the proviso are required to complete an RFI as well as the excel-based templates that have been developed for this purpose. The excel-based templates provide for the required information to be provided by way of –

- an individual disclosure of debtor information; or
- a collective disclosure of debtor information for which homogenous groups have been established.

The volume of debtors and manner in which the taxpayer administers its debt book and associated credit risk will determine which of the formats the taxpayer chooses.

The RFI and excel-based templates provide for the information that the Commissioner must take into account when considering an application for an increased percentage.¹³

¹³ The requirements are set out in A to F of the proviso to section 11(j).

5.5.1 Qualifying debt

Debt that is up to date and considered recoverable, does not qualify for an allowance.

Examples of debt that does not qualify for the allowance include the following:

- Debt repayable in instalments that has experienced two full and consecutive missed payments do not qualify for an allowance as it is only 30 days in arrears. As illustrated above the debt will be considered to be 60 days in arrears when the third full and consecutive payment is missed.
- Short-term debt that is payable on demand will not qualify for an allowance if the outstanding period is shorter than 60 days from due date, which translates into invoice date plus 59 days.
- Short-term debt that is payable within 30 days of invoice will not qualify for an allowance if the outstanding period is shorter than 60 days from due date, which translates into invoice date plus 89 (30 + 59) days.

5.5.2 Calculation of days in arrears and the allowable rate for arrear days

The Commissioner’s discretion to increase the rate applied in calculating the allowance will only be exercised in respect of debt that is 120 days or more in arrears.

Example 3 – Calculation of days in arrears

Facts:

D Debtor purchases clothing on credit from Fashion Clothing on 1 April. The first instalment is due on 30 April. D Debtor misses this repayment. The terms and conditions of the credit agreement provide that Fashion Clothing is entitled to call for the entire amount outstanding once any amount is in arrears.

Result:

The first instalment goes into arrears on 1 May and is in arrears for 30 days on 30 May, the date on which the second instalment falls due. Similarly, the first instalment is considered to be in arrears for 60 days on 30 June, the date on which the third instalment is due.

This can be illustrated as follows:

Instalment	30 April				30 May				30 June				30 July
Days arrears	0	1	2	...	30	31	32	...	60	61	62	...	90

In exercising the Commissioner’s discretion, a list of allowable percentages has been compiled. These percentages are referenced to the contractual delinquency of the debt. Contractual delinquency (CD) is the number of missed payments in relation to a debt and is a consequence of the number of days the debt in question is in arrears.

The table below illustrates the CD and the related allowable percentage for different stages of a debt that is in arrears:

Day category	Instalment category	Allowable Rate
Clean	Clean	N/A
1 – 29 days	CD 1	N/A
30 – 59 days	CD 2	N/A
60 – 89 days	CD 3	25%
90 – 119 days	CD 4	25%
120 – 149 days	CD 5	40%
150 – 179 days	CD 6	50%
180 – 209 days	CD 7	55%
210 – 239 days	CD 8	60%
240 – 269 days	CD 9	65%
270 – 299 days	CD 10	70%
300 – 329 days	CD 11	75%
330 – 364 days	CD 12	80%
1 year +	CD 13	85%

5.5.3 Calculation of the increased percentage under the proviso

The Commissioner will apply the following formula to each debt or group of debtors in initially determining the percentage that may be applied for purposes of calculating the section 11(j)(ii) allowance:

$$\text{Effective percentage} = \frac{[\text{Amount of debt in arrears net of security held} \times \text{PD} \text{ (capped at 85\%)} \times \text{allowance rate (refer table above)}]}{\text{Amount of debt in arrears}}$$

After calculating the effective percentage, the Commissioner will consider all the other relevant considerations as detailed in 5.6 in getting to the percentage that will be used for purposes of calculating the allowance under section 11(j)(ii)(aa) for debt that is 120 days or more in arrears.

Example 4 – Application for an increased percentage directive

Facts:

ABC Finance (ABC) advances R12 000 to Z. The debt is interest bearing and repayable over 36 months. ABC holds security of R500 against this debt. From inception of the debt, Z has never made any repayments to ABC. At the end of ABC's financial year-end, Z is 180 days in arrears and the amount due after interest has been capitalised is R13 086. The terms and conditions of the agreement provide that the full debt becomes due and payable when any of the instalments are in arrears.

ABC does not account for the debt under IFRS and will be entitled to a deduction under section 11(a) if the debt goes bad.

ABC is of the view that the likelihood of recovery of the debt is 20%. The PD is therefore 80%.

Result:

ABC is entitled to a doubtful debt allowance calculated under section 11(j)(ii)(aa) because ABC will be entitled to a deduction under the Act if the debt goes bad and the debt is not accounted for under the IFRS for financial reporting purposes. As the debt is more than 120 days in arrears, ABC may apply to the Commissioner for an increased percentage to be used in calculating the amount of the allowance.

Without directive:

ABC will be entitled to a section 11(j)(ii) allowance of R5 234 in respect of the debt due by Z (R13 086 × 40%).

With directive:

$$\text{Effective percentage} = \frac{\text{[Amount of debt in arrears net of security held} \times \text{PD (capped at 85\%)} \times \text{allowance rate (refer table above)]}}{\text{Amount of debt in arrears}}$$

Therefore,

$$= \frac{\text{[(R13 086 – R500)} \times \text{80\%}^* \times \text{55\%]}}{\text{R13 086}}$$

$$= 42,32\%$$

The Commissioner considers the effective percentage and any other relevant considerations and gives a directive regarding the increased percentage that may be used for purposes of calculating the allowance under section 11(j)(ii)(aa) for debt that is 120 days or more in arrears. The Commissioner will grant ABC a directive authorising the use of 42,32% in the calculation of the allowance under section 11(j)(ii)(aa).

ABC will be entitled to a section 11(j)(ii) allowance of R5 538 in respect of the debt due by Z (R13 086 × 42,32%) when applying the increased percentage authorised in the directive.

In the succeeding year of assessment ABC must include the allowance claimed in income.

5.5.4 Minimum deduction test

Section 11(j)(ii)(aa) allows a taxpayer an allowance of 40% of debt 120 days or more in arrears. Should the formula in 5.5.3 and the consideration of other relevant factors result in a lower effective percentage, the taxpayer will be informed that the default of 40% should be applied and no directive will be issued.

5.6 Factors to be taken into account in issuing a directive for an increased allowance under section 11(j)(i) and (ii)

In order for the Commissioner to consider an application by a taxpayer for an increased percentage allowance under either section 11(j)(i) or (ii), the following factors must be taken into account. Where a taxpayer applies IFRS 9 to the debt for financial reporting purposes, certain of these factors may already have been taken into account in the taxpayers IFRS 9 models. Although the RFI and excel-based templates endeavour to cover all the factors listed below, the onus will be on the taxpayer to carefully consider all the factors and to ensure that full disclosure of all relevant information as detailed has been provided.

5.6.1 The history of the debt owed to that taxpayer, including the number of repayments not met and the duration of the debt

The term “debt” is not defined in the legislation but is understood in the context of section 11(j) to be the portion of debt that is due at year-end that is in default. Debt in default means the full amount of the debt that is due and payable at that point in time. It is not limited to the instalments that are in default but will include the capital if the capital became payable immediately upon default of an instalment.

Debt can originate from money-lending activities, selling goods on credit or providing a service on credit. With the passage of time, the value of such debt will change. Interest, fees and any other agreed charges will be added to the original capital amount whilst payments made by the borrower will reduce the lender’s exposure.

Not all debt is repayable in instalments. Debt could simply be the value of an invoice issued for a service rendered, for example, a medical consultation. Once-off invoices like this are normally payable within 30 days. Should such an invoice remain unsettled in the hands of the service provider, the service provider will qualify for an allowance of 25% at the point of the debt being 60 days in arrears, which will be 90 days after the invoice has been issued.

The allowance that is calculated under section 11(j)(ii) is calculated on the full balance of the debt in the balance sheet at the end of a reporting period, if such balance contains any portion of overdue instalments and the full amount of the debt has become due.

Example 5 – History of the debt and number of repayments not met

Facts:

T Cash Providers (TCP) advanced R12 000 to a client on 1 March 2019. The debt carries interest at a fixed rate of 15%. The debt is repayable over 24 months with the first instalment having fallen due on 31 March 2019. The debtor missed the first scheduled repayment as well as all subsequent repayment dates.

Result:

At 1 April 2019, the client was in default because of missing the first payment. Each subsequent month whereby no payment is received will form part of TCP’s history of the debt. The longer the debt remains unpaid the greater the likelihood that TCP will be able to motivate for an increased percentage under the proviso to section 11(j)(ii).

5.6.2 Steps taken to enforce repayment of debt

The steps taken to enforce repayment will vary from one lender to another. Such steps could range from telephone calls, letters of demand and legal action that could involve part or the whole spectrum of legal process ranging from the issue of summons up to judgment and execution of judgment.

5.6.3 The likelihood of the debt being recovered

Taxpayers are required to consider the likelihood of debt being recovered. In order to use the likelihood of recovery to support the use of an increased rate in calculating the doubtful debt allowance, the taxpayer is required to provide such likelihood as a percentage value. The likelihood of recovery will vary from borrower to borrower and will depend, amongst other things, on the borrower's credit profile, which is impacted by past behaviour. The opposite of the likelihood of recovery is generally referred to as the PD. If the likelihood of recovery is 66% then the PD is 34% (100% – 66%).

The onus is on the taxpayer to have supporting evidence at hand which would support the likelihood of recovery and PD that was assigned to a debtor or a group of debtors.

In respect of debts to which IFRS 9 applies for reporting purposes, the PD is embedded in the IFRS models, which takes into account a number of factors. In the exercise of the Commissioner's discretion in respect of debts to which IFRS 9 is not applied for financial reporting purposes, the PD is capped at 85%. Inherent in all doubtful debt books is an element of debtors that will be recoverable after steps are taken to enforce the debt. Such steps may include handing the debt over to specialist collection agencies. This recovery percentage is assumed to be at a level of 15% and as such the maximum PD that will be applied is 85%. The PD to be used can lie anywhere between 0% and 85%.

5.6.4 Any security available in respect of that debt

Taxpayers are required to include the realisable value of all security held in respect of each debt for which an increased percentage allowance is applied for. Such security reduces the value of the debt that is considered doubtful as it constitutes an indirect recovery of debt. In this regard it is important that all security held must be disclosed and that all disclosed realisable values are supported by appropriate documentation.

5.6.5 The criteria applied by the taxpayer in classifying debt as bad

A taxpayer should write off non-performing debt at the point in time when there is no reasonable expectation of further material recoveries. SARS does not accept that a debt is bad for tax purposes if, notwithstanding that the debt has been written off as bad for accounting purposes under either IFRS 9 or not, the taxpayer still pursues its recovery through alternative processes, for example, the appointment of a debt collection agency to recover the debt on behalf of the taxpayer. The criteria applied by a taxpayer in classifying a debt as bad for tax purposes could be expressed as the period that debt and its associated provision are held on balance sheet before the entity believes that no further material recoveries would be collected. Taxpayers are required to provide full details of all the factors it takes into account before classifying a debt as bad.

5.6.7 Such other considerations as the Commissioner may deem relevant

Taxpayers may be required to provide information in addition to the above factors in support of their application for a directive. This information will be requested on a case-by-case basis.

5.7 Duration of section 11(j) directive

The calculation of the allowances in section 11(j) is an annual event and as such the application for a directive for an increased percentage to be used in the calculation of the allowance must be made annually. This annual application will be made through the completion of the model template on an annual basis, which needs to be submitted before submission of the taxpayer's tax return. The RFI does not need to be completed on an annual basis. Taxpayer's that have been granted a directive will be entitled to apply such directive provided that the taxpayer's circumstances, IFRS and/or the legislative criteria related to credit loss provisioning remains unchanged between the initial submission of the request for a directive and the end of the year of assessment and the model template is submitted annually as required.

It is understood that many changes will be observed over the years following the initial recognition of a debt. It is important to distinguish "economic-related" changes which will affect the level of provisioning from changes made to the assumptions underpinning the model.

Any model or methodology changes could potentially impact on a taxpayer's estimates for provisional payments and as such the application should be made before the date on which such provisional payments become due.

Economic-related changes comprise –

- change in the probability of a debt becoming irrecoverable when compared to the probability at origination;
- interest rate forecast changes;
- forward-looking-information view changes; or
- any other data inputs.

Model-related changes comprise –

- trigger changes that signify a significant increase in credit risk;
- policy changes in how an entity recognises the transfer of a debt between stages;
- changes to definition of default; or
- any methodology changes and/or subsequent model recalibration.

For taxpayers who apply the provisions of IFRS 9 for financial reporting purposes, any model-related changes as described above made to the model will result in the directive becoming invalid and will require the taxpayer to re-apply for the directive. This will require the taxpayer to provide detailed information and explanations, complete a revised RFI as well as detailed excel-based templates, clearly showing the impact of the change on the same set of numbers but calculated by the two different models.

For those taxpayers that do not apply IFRS for financial reporting purposes, any changes made to the manner in which the taxpayer obtains PDs or any other assumption changes will result in the directive becoming invalid. These taxpayers will need to re-apply for a directive, by providing detailed information regarding the assumption changes, complete a revised RFI as well as detailed excel-based templates, clearly showing the impact of change on the same set of numbers resulting from these assumption changes.

6. Conclusion

Taxpayers that have debts due to them that are considered doubtful are entitled to an allowance in respect of such doubtful debts. The calculation of the allowance for doubtful debts is dependent on whether the taxpayer applies IFRS 9 to debts due for financial reporting purposes or not. The default allowances are 25% and 40% of the base specified in the Act depending on various factors.

Taxpayers may apply to the Commissioner for an increased percentage allowance in case of debt initially falling into the category that qualifies for a 40% rate; the increased percentage is limited to 85%. These applications must be made in the manner as prescribed by the Commissioner from time to time.

SOUTH AFRICAN REVENUE SERVICE