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# Interpretation Bulletin IT-442R

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## Bad Debts and Reserves for Doubtful Debts



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REFERENCE: REFERENCE: Paragraphs 20(1)(p) and 20(1)(l) (also sections 12.4, 22 and 10.6; subsections 20(4), (4.1), (4.2) and (27), 39(11), 50(1), 98(3) and and the definition of "amortized cost" and "lending asset" in 248(1); and paragraphs 12(1)(d), (i) and (i.1), 18(1)(e), 20(1)(n), 54(b) and 69(1)(b))

## **Application**

This bulletin cancels and replaces IT-442 dated February 11, 1980. This bulletin applies for taxation years and fiscal periods beginning after June 17, 1987 and ending after 1987. For taxation years and fiscal periods beginning before June 18, 1987 or ending before 1988, please refer to the law.

## **Summary**

This bulletin discusses the deduction of bad debts, and of amounts in respect of uncollectible loans or lending assets by an insurer or a taxpayer whose ordinary business includes the lending of money. As well, the bulletin discusses the inclusion in income of the subsequent

recovery of any such amounts. It also deals with the determination of reserves for doubtful debts.

## **Discussion and Interpretation**

### **Bad Debts**

1. Subparagraph 20(1)(p)(i) authorizes a deduction for a bad debt if the following requirements are met:

- (a) the debt was owing to the taxpayer at the end of the taxation year,
- (b) the debt became bad during the taxation year, and
- (c) the debt was included or is deemed to have been included in the taxpayer's income for that taxation year or a previous taxation year.

The requirement in (a) above prohibits a deduction under subparagraph 20(1)(p)(i) where a debt was sold, discounted or assigned absolutely by the taxpayer during the course of the year, even though the taxpayer may remain liable to indemnify the purchaser or assignee if the debt should prove to be uncollectible. However, where such a debt was of a kind that would have qualified

for consideration as a bad debt had it been retained until the end of the taxation year, any loss at the time of its disposition, or later because of non-payment by the debtor, would normally be deductible by the taxpayer as a general business expense. Such loss would be deductible provided the disposition of the debt was made in the ordinary course of the business or as part of trading in accounts receivable.

2. Where all debts (including the debts arising from certain loans) are disposed of as part of the disposition of the whole or a substantial part of a business, the vendor and the purchaser of the business may elect jointly under section 22 in respect of the debts. This election allows the vendor to deduct any loss incurred on sale of the debts (excluding those previously written off as bad debts under paragraph 20(1)(p)), and the purchaser is required to include the same amount in income for the year of the sale. The purchaser may then deal with the debts for tax purposes as though they had arisen during the course of the purchaser's business. For details about the section 22 election, refer to the current version of IT-188, Sale of Accounts Receivable.

3. On the other hand, where a debt was assigned, but not absolutely, by the taxpayer during the course of the year, the debt is considered to be owing to the taxpayer at the end of the taxation year even though the taxpayer may be liable to furnish the assignee with other security if the assigned debt should prove to be uncollectible. The term "assigned", as used in this paragraph, refers to a transfer of a debt to a third party (the assignee) by the taxpayer for the purpose of securing a debt owing or a loan payable by the taxpayer to the assignee. The transfer normally gives the assignee the right to collect the money on the assigned debt which is applied as a payment of the debt owing to the assignee by the taxpayer.

4. A debt continues to be a debt owing to the taxpayer at the end of the taxation year even though it was written off as a bad debt during the year. If a taxpayer follows the practice of writing off bad debts during the course of a taxation year rather than waiting until the end of the year, any recoveries made later in the year are not brought into income under paragraph 12(1)(i). However, such recoveries will reduce the amount allowed to be written off for tax purposes, since the maximum amount that may be claimed as a bad debt is only the net amount of a debt at the end of the taxation year.

5. As indicated in 1(b) above, a bad debt may be claimed in a taxation year only if the debt became bad in that year regardless of how long the debt may have been outstanding. It also follows that a deduction for a debt that became bad in one taxation year cannot be deferred and claimed in a subsequent taxation year.

Where it is considered that a part of a debt is collectible and a part is not, a portion only of the debt may be viewed as a bad debt.

6. There are no specific conditions that must be met before a debt may be classed as a bad debt. Such a decision should be made only after determined efforts to collect the debt have been unsuccessful or there is clear evidence to indicate that it has in fact become uncollectible. If a debt is merely doubtful of collection, it should not be claimed as a bad debt but should be considered for purposes of a reserve for doubtful debts. The fact that a recovery is made after a debt is written off does not negate the correctness of a claim for a bad debt if the recovery could not reasonably have been foreseen at the time the debt was written off.

7. Where a taxpayer is deemed by paragraph 69(1)(b) to have received an amount that is greater than the amount actually received in a non-arm's length disposition of property, or any gift inter vivos,

the difference between the amount deemed to have been received and the amount actually received is not a bad debt.

8. As outlined in 1(c) above, only a debt that was previously included or deemed to have been included in income may qualify for purposes of a bad debt deduction. The fact, however, that a bad debt may fail to be deductible for this reason does not necessarily mean that the loss is not deductible under other provisions of the Act. For example, a taxpayer who is in the business of purchasing trade receivables is entitled to claim as a general business expense any loss on the disposition or realization of the receivables. Similarly, a taxpayer who makes advances to an employee to be recouped out of future commissions to be earned by the employee may be entitled to deduct the non-recoverable portion of such advances as a general business expense.

9. The sale of a capital asset may entitle the vendor to receive interest on any portion of the sales price that is owing. If such interest was reported on a receivable or accrual basis, a deduction under subparagraph 20(1)(p)(i) may be claimed for any part of such interest that proved to be uncollectible but not for any part of the principal amount that was not collected (see 16 below). If the sale involved a

depreciable property (other than a timber resource property-see subsection 20(4.1)), any subsequent loss would not be deductible under subparagraph 20(1)(p)(i) but would be subject to the specific rule in subsection 20(4). Refer to the current version of IT-220, Capital Cost Allowance Proceeds of Disposition of Depreciable Property for further information.

### **Uncollectible Loans or Lending Assets**

10. Subparagraph 20(1)(p)(ii) allows a taxpayer who is an insurer or whose ordinary business included the lending of money to obtain a deduction for that part of the amortized cost at the end of the year of an uncollectible loan or lending asset made or acquired in the ordinary course of business. Subsection 20(27) provides that a loan or lending asset will be deemed to be so acquired by such a taxpayer where it was acquired at fair market value by the taxpayer from a non-arm's length person who was an insurer or whose ordinary business included the lending of money and the loan or lending asset was made or acquired in the ordinary course of that person's business of insurance or the lending of money. The terms "amortized cost" and "lending asset" are defined in subsection 248(1). The comments in 3 to 6 above relating to the

determination of when a debt is considered owing, and of the amount thereof that is a bad debt in the year, also apply to loans and lending assets established to have become uncollectible in the year.

11. For an amount to be deductible on the basis that the taxpayer's ordinary business included the lending of money, it is not necessary that the taxpayer be a money-lender within the restrictive meaning that may be given to that term in a governing statute. However, it is not sufficient merely that loans are made; they must be made as an integral part of a business operation. It is required that there be a certain system and continuity in the making of loans, and the purpose must not be the occasional investment of surplus funds, accommodation to friends or customers or advances that are intended to remain a part of the capital of the borrower.

12. It does not follow that because a taxpayer's ordinary business includes the making of loans, every loan made is necessarily made in the ordinary course of that part of the business. A taxpayer who is in the money-lending business, as in the case of any other taxpayer, may make loans that are not prompted by the ordinary considerations that govern the making of loans in a money-lending business.

13. In certain industries or occupations where the primary purpose of business is not the lending of money, it may be the practice or custom that loans or advances are made in the ordinary course of the business. An example might be the lumber industry where it has been the custom for manufacturers or wholesalers to make temporary advances to loggers which are repayable out of deliveries. Another example would be the case of a self-employed insurance agent who adopts the practice of paying the net premiums to the insurer when a policy is written and of collecting the gross premium from the insured at a later date, thus in effect making a loan to the insured. Advances made for purposes of this kind that are directly related to the business of the taxpayer are deductible under subparagraph 20(1)(p)(ii) when they become uncollectible in the year.

### **Property Received in Settlement of a Debt, Loan or Lending Asset**

14. A taxpayer may accept property, for example, securities or real estate, in full settlement of a trade debt or of a loan or lending asset made or acquired in the ordinary course of the business. Where such debt, loan or lending asset is of a kind that would qualify for consideration under paragraph 20(1)(p) and the fair market value of

the property received by the taxpayer at the date of acquisition is less than the amount owing or amortized cost, the difference is deductible as a bad debt or uncollectible loan or lending asset. If the property is retained by the taxpayer for a period of time which, in the circumstances, indicates that it was held as an investment, any subsequent disposition is considered to be the disposition of a capital property and is subject to the rules relating to capital gains and capital losses. However, if the property was disposed of in circumstances indicating that the taxpayer did not have the intention of retaining it as an investment, any loss on the disposition, i.e. fair market value when acquired minus proceeds of disposition, is a business loss. On the other hand, if the property should realize an amount that was greater than the fair market value at the date of acquisition, the difference constitutes business income.

15. The situation described in 14 above must be distinguished from that where the property is acquired by the taxpayer as an investment and, in exchange, the taxpayer removes from accounts receivable part or all of a trade debt owing to the taxpayer by the vendor of the property, or the amount of a loan owing or lending asset is reduced or extinguished entirely. Any subsequent disposition of the property so received in exchange is considered to be the disposition of a

capital property and is subject to the rules relating to capital gains and capital losses.

### **Bad Debts from Sale of Capital Property**

16. Where a debt that arose on the sale of a capital property as defined by paragraph 54(b) has become a bad debt during the year, no amount is deductible under paragraph 20(1)(p) in respect of the debt. The provisions of subsection 50(1) deem the debt to have been disposed of at the end of the year and any loss on the debt is a capital loss, with any subsequent recovery being a capital gain. In this connection, see the current version of IT-159, Capital Debts Established to be Bad Debts for further information.

17. A taxpayer who has purchased trade receivables of another person cannot claim a deduction under subparagraph 20(1)(p)(i) for losses incurred on the realization of these accounts except as discussed in 2 above. Any loss on the disposition of the purchased accounts is a capital loss unless 8 above applies. If, therefore, at a particular taxation year-end subsequent to the purchase, it is determined that any one of the purchased accounts receivable has become uncollectible, and an amount is not otherwise deductible in

respect of the debt because it is a capital property, the provisions of subsection 50(1) apply.

### **Bad Debts from Sale of Eligible Capital Property**

18. The uncollectible portion of a debt arising on the disposition of an eligible capital property after June 17, 1987 (other than on a disposition pursuant to the terms of an obligation entered into in writing before June 18, 1987) may be subject to a deduction under subsection 20(4.2). Generally, subsection 20(4.2) provides for a deduction of an amount equal to three-quarters of the uncollectible portion of the debt less the deemed taxable capital gain generated under subparagraph 14(1)(a)(v) on disposition of the eligible capital in respect of which a capital gains deduction was claimed under section 110.6. The reference to three-quarters above should be changed to one-half where, in the case of a corporation, the eligible capital property was disposed of in a taxation year beginning before July, 1988 and, in any other case, the disposition occurred in a fiscal period beginning before 1988. To the extent that the deduction in respect of the uncollectible debt is denied because it related to a deemed taxable capital gain in respect of which a deduction was

taken under section 110.6, it is deemed to be an allowable capital loss.

## **Recoveries of Bad Debts or Uncollectible Loans or Lending Assets**

19. Paragraph 12(1)(i) requires a taxpayer to include in income any amount received as a recovery on a bad debt or uncollectible loan or lending asset which the taxpayer has deducted in computing income in a previous taxation year. Normally, the deduction in the previous year would have been claimed under paragraph 20(1)(p) but paragraph 12(1)(i) is not restricted to such circumstances. For instance, paragraph 12(1)(i) is applicable to a recovery of part or all of the former proceeds of disposition of a depreciable property to the extent that the amount has previously been deducted pursuant to subsections 20(4) or (4.1). A recovery on a bad debt or uncollectible loan or lending asset may also be achieved by a sale of the debt, loan or lending asset. For example, the taxpayer may locate a third party who owes money to the debtor and may sell a debt to that person, probably at a discount, to be used by the third party as an offset against the amount owing to the debtor. The proceeds

received by the taxpayer from the sale of the debt would constitute a bad debt recovery.

20. Paragraph 12(1)(i) does not apply to recoveries on bad debts from debts acquired on the disposition of a capital property (other than depreciable property – see 19 above) or eligible capital property. Any recovery or disposition of a bad debt resulting from the disposition of a capital property (other than a depreciable property) is included in the computation of capital gains in the year of recovery (see the current version of IT-159). The recovery or disposition of a bad debt resulting from the disposition of a depreciable property (other than a timber resource property) is a capital gain to the extent that the amount is not required to be included in income by paragraph 12(1)(i). To the extent that the recovered amount related to a previous income deduction under subsection 20(4.2) that resulted from the disposition of eligible capital property after June 17, 1987 (see 18 above), paragraph 12(1)(i.1) provides that up to three-quarters (one-half where the portion of the bad debt deducted was one-half) of the amount so recovered is to be included in income. The amount included in income under paragraph 12(1)(i.1) is proportional to the subsection 20(4.2) deduction previously claimed. To the extent that

three-quarters of the recovered amount is not included in income under paragraph 12(1)(i.1) it is deemed, under subsection 39(11), to be a taxable capital gain in the year of recovery from the disposition of a capital property which may be subject to the capital gains deduction under section 110.6.

### **Property Included in Inventory**

21. Where, in a taxation year, a taxpayer disposes of a property included in inventory in respect of which an amount has previously been deducted under paragraph 20(1)(p), section 12.4 requires that any excess of the previous deductions over previous recoveries in respect of that property under paragraph 12(1)(i) must be included in the taxpayer's income for that year. As a consequence, a taxpayer is prevented from claiming both a deduction under paragraph 20(1)(p) and a loss on sale of a property that is part of the taxpayer's inventory.

### **Reserve for Doubtful Debts**

22. Paragraph 20(1)(l), which permits the deduction of a reserve for doubtful debts under subparagraph (i) thereof, and a reserve for doubtful loans or lending assets under subparagraph (ii), is an

exception to the general prohibition in paragraph 18(1)(e) against the deduction of reserves. A reserve claimed by a taxpayer under paragraph 20(1)(l) for one taxation year must be included in income in the following taxation year pursuant to paragraph 12(1)(d). Thus the reserve claimed for a taxation year is always a new reserve and the whole of the reserve is subject to the conditions specified in paragraph 20(1)(l), and not merely any increase in the reserve as it may appear in the taxpayer's accounts. The comments in 10 to 13 above on the requirements that the taxpayer be an insurer or whose ordinary business includes the lending of money and that the loan or lending asset was made or acquired by the taxpayer in the ordinary course of the taxpayer's business of insurance or the lending of money also apply for purposes of subparagraph 20(1)(l)(ii).

23. The requirements for a reserve for doubtful debts claimed under sub-paragraph 20(1)(l)(i) are the same as those specified in subparagraph 20(1)(p)(i) for bad debts as summarized in 1 above, except as to the degree of doubt concerning the collectibility of the debts. For a debt to be classed as a bad debt, there must be evidence that it has in fact become uncollectible. It is sufficient, however, that there is reasonable doubt about the collectibility of a debt for it to be included in a reserve for doubtful debts. Many of the

comments in 1 to 9 above regarding bad debts, with appropriate modifications to names and terms as required, apply equally to a reserve for doubtful debts.

24. For a taxpayer to establish that a reserve for doubtful debts is reasonable in amount it is necessary to identify the debts that are doubtful of collection having regard for such indications as the period of arrears or default, the financial status and prospects of the debtor, the debtor's past credit record both with the taxpayer and, if available, with other creditors, the value of any security taken and any other factor that is relevant in judging the debtor's ability or willingness to pay. Once having identified which debts are doubtful, the maximum amount of the reserve should be calculated based on an estimate as to what percentage of the doubtful debts will probably not be collected. This calculation should preferably be based on the taxpayer's past history of bad debts, the experience in the industry if that information is available, general and local economic conditions, costs of collection, etc. This procedure may result in a reserve being calculated as a percentage of the total amount of the doubtful debts or a series of percentages relating to an age-analysis of those debts. However, a reserve that is merely based on a percentage of all debts, whether doubtful or not, a percentage of gross sales or

some similar calculation is not considered to be a reserve determined on a reasonable basis as required by subparagraph 20(1)(l)(i). However, a reserve for doubtful debts that is less than the amount that could have been claimed in accordance with a determination such as that described above will be viewed as a "reasonable" amount.

25. The fact that provincial or other legislation may require a taxpayer to maintain a certain reserve in respect of outstanding debts is not a determining factor in establishing the reasonableness of the amount of the reserve for doubtful debts claimed under paragraph 20(1)(l). A reserve set up to provide for a possible reduction in accounts receivable resulting from the return of merchandise sold on credit is not a reserve for doubtful debts but is a reserve for a contingency, subject to the prohibition in paragraph 18(1)(e).

26. Although the length of time that an account is in arrears is generally an important consideration in deciding whether the account is doubtful of collection, in certain circumstances a lengthy delay may occur without the account being so considered. For example, a foreign debtor may be forced to delay payment because of currency

restrictions and there may be no real doubt about the eventual payment of the debt. Similarly, a deferment of payment for a number of years, agreed upon by the creditor, to overcome a cash flow problem of the debtor, does not in itself entitle the creditor to claim a deduction for a reserve under paragraph 20(1)(l).

27. Where stock in trade, including land, is sold on an extended deferred payment basis in the circumstances set out in paragraph 20(1)(n) of the Act, a reserve for the profit element in the amount receivable may be claimed under that paragraph. However, a reserve in respect of the debt itself may still be claimed under paragraph 20(1)(l) – For comments on the relationship between reserves under paragraphs 20(1)(n) and 20(1)(l), see the current versions of IT-152, Special Reserves – Sale of Land, and IT-154, Special Reserves.

### **Cessation or Sale of Business**

28. Where a taxpayer (an individual or a corporation) on the accrual basis ceases to carry on a business at a time when there were debts, or loans or lending assets, or where the business is sold but debts or loans or lending assets are retained, the provisions of the Act relating to a reserve for doubtful debts, or a reserve for doubtful

loans or lending assets, bad debts or uncollectible loans or lending assets and their recoveries remain applicable. Any loss or gain resulting from the application of those provisions during the period of time the debts or loans or lending assets are being collected is to be taken into account in computing the taxpayer's income for the year or years involved. However, where a corporation is wound up, debts or loans or lending assets becoming bad or uncollectible in the final year are deductible but a reserve for doubtful debts or doubtful loans or lending assets, may not be claimed for that year. If a partnership is dissolved in circumstances such that subsection 98(3) applies, each partner becomes entitled to a deduction under paragraphs 20(1)(l) and 20(1)(p) in respect of accounts receivables taken over directly.

29. Where a taxpayer sells a business, including debts, or loans or lending assets, any reserves for doubtful debts or doubtful loans and lending assets allowed at the end of the preceding taxation year should be included in income of the current year. However, such reserves are not allowable for the year in which the business is sold, for the debts or loans and lending assets which were sold, since they were not owing to the taxpayer at the end of the year after the sale of the business.