



INLAND REVENUE BOARD OF MALAYSIA

**TAX TREATMENT OF WHOLLY & PARTLY
IRRECOVERABLE DEBTS AND DEBT
RECOVERIES**

PUBLIC RULING NO. 4/2019

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INLAND REVENUE BOARD OF MALAYSIA **Public Ruling No. 4/2019**
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DIRECTOR GENERAL'S PUBLIC RULING

Section 138A of the Income Tax Act 1967 (ITA) provides that the Director General of Inland Revenue is empowered to make a Public Ruling in relation to the application of any provisions of the ITA.

A Public Ruling is published as a guide for the public and officers of the Inland Revenue Board of Malaysia. It sets out the interpretation of the Director General in respect of the particular tax law and the policy as well as the procedure applicable to it.

The Director General of Inland Revenue may withdraw this Public Ruling either wholly or in part, by notice of withdrawal or by publication of a new ruling.

**Director General of Inland Revenue,
Inland Revenue Board of Malaysia.**

1. Objective

The objective of this Public Ruling (PR) is to explain the tax treatment of –

- i) wholly and partly irrecoverable debts as a deduction against gross income of a person from a business for the basis year for a year of assessment (YA); and
- ii) recoveries of wholly and partly irrecoverable debts where a deduction has been made in ascertaining the adjusted income for an earlier YA.

2. Relevant Provisions of the Law

- 2.1 This PR takes into account laws which are in force as at the date this PR is published.
- 2.2 The provisions of the Income Tax Act 1967 (ITA) related to this PR are section 2, subsection 22(2), 24(5), sections 30 and 34.

3. Interpretation

The words used in this PR have the following meaning:

- 3.1 "Bad debt" is a debt arising from trade in which the debt has been included in the gross income of a business of a person for the basis period for a YA prior to the relevant YA that it is reasonably estimated to be irrecoverable after reasonable steps have been taken to recover it.
- 3.2 "Recoveries" are money or assets received in connection with a trade debt that has been written off as bad in an earlier period.
- 3.3 "Gross income" of a person from a source for the basis period for a YA is the gross income as ascertained in accordance with section 22 of the ITA.
- 3.4 "Adjusted income" in relation to a business source and a basis period, means adjusted income ascertained in accordance with sections 33 and 34 of the ITA.
- 3.5 "Person" includes a company, a body of persons, a limited liability partnership and a corporation sole;

- 3.6 "Basis period" in relation to a person, each source of his and a YA, means such basis period, if any, as is ascertained in accordance with section 21 or 21A of the ITA.
- 3.7 "Year of assessment", subject to subsection 2(5) of the ITA, means calendar year.
- 3.8 "Related or connected person" means any person who is in a position to influence or be influenced by the other person in any significant way or to any substantial degree, or to control or be controlled by the other person, and includes:
- a) In the case of an individual: a spouse, relative, an associate or a person controlled by a relative or associate;
 - b) In the case of a company: a director, a related company or its directors, a relative of a director, or a person who controls or is controlled by the company;
 - c) In the case of a partnership: a partner, a relative of a partner, or a person who controls or is controlled by a partner;
 - d) In the case of a co-operative society: a member of the board, committee or other governing body of the co-operative society, or a person who controls or is controlled by the co-operative society;
 - e) In the case of any other body, association or group of persons: a person having the direction or control of the management of its business or affairs, including an administrator; a beneficiary; a karta; a member of the board, committee, council or other governing body; a trustee; or a person who controls or is controlled by that body, association or group of persons.
- 3.9 "Relative", in relation to a person, includes
- a) a parent;
 - b) a child (including a stepchild and a child adopted in accordance with any law);

- c) a brother or a sister;
- d) an uncle or an aunt;
- e) a nephew or a niece;
- f) a cousin;
- g) an ancestor; or
- h) a lineal descendant.

3.10 "Associate", in relation to a person, means:

- a) a person in any of the following relationships to that person, that is to say, husband or wife, parent, child, brother, sister and partner;
- b) the trustee of a settlement in relation to which that person is, or any such relative of his (living or dead) as is mentioned in paragraph a) above or a settlor;
- c) where that person is interested in any shares or obligations of a company which are subject to any trust or are part of the estate of a deceased person, any other person interested therein.

3.11 "Director" in relation to a company, includes any person occupying the position of director (by whatever name called), any person in accordance with whose directions the directors are accustomed to act and any person who –

- a) is a manager of the company or otherwise concerned in the management of the company's business;
- b) is remunerated out of the funds of that business; and
- c) is, either on his own or with one or more associates (as interpreted in paragraph 3.10), the beneficial owner of (or able directly or through the

medium of other companies or by any other indirect means to control) twenty percent or more of the ordinary share capital of the company.

- 3.12 "Related company" has the same meaning as in subsection 2(4) of the ITA and controlled in the same manner described by section 139 of the ITA, by not more than 5 persons.
- 3.13 "Business or commercial considerations" refer to the informations, factors, and circumstances that any other person in that particular person's business and /or position acting at arm's length would have taken into consideration in making that business or commercial decision.
- 3.14 "Arm's length basis" refers to the circumstances, decisions or outcomes that would have been arrived at if unrelated or unconnected persons were to deal with each other wholly independently and out of reach of personal influence.

4. Introduction

Debts which are allowed as a deduction in ascertaining the adjusted income of a business is a trade debt which is irrecoverable either wholly or partly. Such debt is written off as bad. Trade debt is a debt that arises from the sales of goods or services and has been included in the gross income of the business.

Reasonable consideration should be taken before writing off a trade debt as bad and then allowed as a deduction in ascertaining the adjusted income of a business. Reasonable steps to recover the debt should be taken before any decision is made to write off the debt.

Subsection 34(2) of the ITA allows a trade debt which is reasonably estimated to be irrecoverable either wholly or partly, to be deducted from gross income in computing the adjusted income of the business.

Where a trade debt is written off as bad or an amount of debt which is estimated to be irrecoverable has been subsequently received, the total debt which is recovered shall be regarded as a gross income of the business since deductions have been made in relation to the debt and such estimates (provision).

5. Irrecoverable Debts

- 5.1 Trade debts exist when sales are made but payments are not received. For example, a seller supplied its stock-in-trade to a buyer and for some reason,

the buyer cannot make payment on the stocks that has been sold to him. The amount which is unpaid is a trade debt or a business debt and is a loss to the seller's business because the sale has been included in the gross income of the seller. Trade debts which have long not been paid and have been identified as wholly irrecoverable are known as bad debts. Typically bad debts will be written off and claimed as deductions in ascertaining the adjusted income of the business.

- 5.2 In order for a trade debt to be written off as bad and allowed as a deduction against the gross income in ascertaining the adjusted income of the business, generally two conditions are to be fulfilled. The first condition is that the debt shall be an amount that has been included in the gross income of a person for the basis period for a YA prior to the relevant YA. The second condition is such debt is a debt which is irrecoverable.
- 5.3 Sound considerations should be taken by the person carrying the business before a trade debt can be written off. All circumstances of the debt such as the likelihood and cost of its recovery should be considered before a decision is made to write off the debt.

5.3.1 Steps taken to recover the debt

All reasonable steps based on sound commercial considerations should be taken to recover the debt. To support a claim for deduction of a bad debt written off for tax purposes, there should be sufficient evidence of such steps taken, **including** one or more of the following:

- a) issuing reminder notices;
- b) debt restructuring scheme;
- c) rescheduling of debt settlement;
- d) negotiation or arbitration of a disputed debt; or
- e) legal action (filing of civil suit, obtaining of judgement from the court and execution of the judgement).

The steps that should be taken depends on the amount of the irrecoverable debt and to be written off and/or the anticipated cost effectiveness of each action. If the amount of the debt and the anticipated cost hinders any action to pursue the debt, the reasons should be documented.

To support a claim for deduction for tax purposes, the decision made should be based upon valid commercial considerations and not for personal, private or other reasons. It should be considered a reasonable basis if it can be shown that the anticipated cost of any legal action is prohibitive in relation to the amount of debt.

The evidence showing the following must also be made available in the event of a tax audit to qualify for a deduction for tax purposes:

- a) that each debt has been evaluated separately;
- b) when and by whom this was done; and
- c) what specific information used in arriving at that evaluation.

5.3.2 Circumstances when a debt can be considered as irrecoverable

Debts which are irrecoverable become bad (either wholly or partly) when all reasonable steps have been taken to recover such debt. As long as there are any other reasonable steps for recovery , such debt cannot be written off as bad.

After reasonable steps for recovery as in paragraph 5.3.1 have been taken, a debt can be considered as wholly irrecoverable or bad on the occurrence of any one of the followings:

- a) the debtor has died without leaving any assets from which the debt can be recovered;
- b) the debtor is a bankrupt or under liquidation and there are no assets from which the debt can be recovered;
- c) the debt is statute-barred;

- d) the debtor cannot be traced despite various attempts and there are no known assets from which the debt can be recovered;
- e) attempts at negotiation or arbitration of a disputed debt have failed and the anticipated cost of litigation is prohibitive; or
- f) any other circumstances where there is no likelihood of cost effective recovery.

Example 1

Abadi Sdn. Bhd., a wholesaler, supplied goods worth a total of RM10,000 on various dates in 2015 to Bersatu Mini Market. Various payments totalling RM6,500 were received. However, it was later discovered that the mini market had closed down and the sole proprietor could not be contacted. Reasonable steps had been taken to recover the debt including tracing the debtor at his last known business and residential addresses, but to no avail. The company decided to write off this debt in its Income Statement for the year ended 31.12.2017.

Debt of RM3,500 (RM10,000 - RM6,500) is a bad debt which is allowed as a deduction in computing the adjusted income of a business as the debt has arisen from transactions that have been included in the gross income of the business and all reasonable steps have been taken to recover the debt but it cannot be recovered.

Example 2

Chanteq Sdn. Bhd. took over the retail business of an existing partnership. Among the assets taken over included trade debts amounting to RM30,000. During its first two years of operation, the company managed to collect all the debts that had been taken over from the partnership, except for a debt of RM2,000 as the debtor could not be traced.

The company decided to write off this debt in the Income Statement in the second year of business. Although the debt was originally a trade debt in the accounts of the partnership, the amount constituted a non-trade debt of Chanteq Sdn. Bhd. as it had arisen from taking over of the assets of the partnership and not from a transaction that was

included as gross income of the company. Therefore, the amount of RM2,000 written off as a bad debt **cannot** be allowed as a deduction in computing the adjusted income. Conversely, the recoveries amounting to RM28,000 should not be regarded as taxable.

5.3.3 Debt recoveries allowable as deductions

If the amount of bad debts written off and allowed as a deduction in ascertaining the adjusted income is recoverable, the amount recovered must be included in the gross income for the basis period the amount is received - paragraph 22(2)(a) of the ITA. Therefore, any trade debt recovered which was previously written off as bad should be reflected in the Income Statement in the period in which it was received. If the recovery is not included in the Income Statement but is otherwise included in the reserve or other accounts, an adjustment is required in the tax computation.

Example 3

Purnama Sdn. Bhd. wrote off RM2,700 which was a trade debt of Qalif (who had passed away) for the year ended 30.9.2017. In the same financial year, the company received RM2,000 from Rayyan, whose trade debt was written off and allowed as a deduction for tax purposes three years ago because he could not be contacted.

The amount of RM2,700 being Qalif's trade debt which was written off as a bad debt was allowed as a deduction and the recovery of RM2,000 received from Rayyan is taxable. If both of these amounts are shown in the Income Statement for the year ending 30.9.2017, no adjustment is required in the tax computation.

If the recovery of RM2,000 is not entered into the Income Statement, an adjustment for that amount should be made in the tax computation .

5.3.4 Giving Loans or Advancement is the Ordinary Course of Business

Paragraph 5.2 specifies that one of the conditions to enable a trade debt to be written off as a bad debt and be allowed as a deduction in ascertaining the adjusted income of a business is that the amount of debt has been included in the gross income for the basis period for a YA prior to the relevant YA. However, this term shall not apply in a

case where the nature of a business is giving loans and advancement, for example a moneylender company, a bank or a person giving loans in the course of its business.

For such a business, subsection 34(3) of the ITA provides that the interest (which has been included in the gross income) and the loan are considered as a debt. Where such debt is irrecoverable partly or wholly and is written off as a bad debt (after all reasonable steps are taken and all circumstances are considered), both the interest and the loan that are written off shall be allowed as a deduction in arriving at the adjusted income of the business.

6. Doubtful debts

- 6.1 For a debt which is doubtful to be recovered, a reasonable estimation for such debt as a provision has to be prepared. A provision is an expense which is not allowable since it does not fulfill the meaning of 'incurred'. However, subsection 34(2) of the ITA allows a provision made for trade debts which are reasonably estimated to be irrecoverable as a deduction in ascertaining the adjusted income of a business. The provision for doubtful debts is an estimation made for debt which are irrecoverable or debts becoming bad.

Subsection 34(2) of the ITA is a special provision which allows a trade/business debt which is reasonably estimated to be irrecoverable either wholly or partly as a deduction in ascertaining the adjusted income from a business of a person for the basis period for a relevant YA. The debt is a debt arising from the sale of stock-in-trade or provision of services which is estimated to be irrecoverable and that amount of debt has been included as the gross income of a person for the basis period for a YA prior to the relevant YA - paragraph 34(3)(a) of the ITA.

- 6.2 Bad debts are trade /business debts which are reasonably estimated to be wholly irrecoverable at the end of the relevant period - paragraph 34(2)(a) of the ITA. Doubtful debts are trade/business debts which are reasonably estimated to be partly irrecoverable in which the debt is doubtful to be fully recoverable - paragraph 34(2)(b) of the ITA. It is a trade debt that has not yet been paid off but has the hope to be partly recovered.

There are two types of provisions for doubtful debts, i.e. specific and general provision for doubtful debts.

6.2.1 Specific provision for doubtful debts

Trade doubtful debt is a long unpaid debt but there is still hope to be recovered either wholly or partly. Where there is some reasonable basis that recovery of a trade debt is doubtful (based on valid commercial considerations but not personal, private or other reasons), a specific provision can be made at the end of the accounting period for the amount of the debt which is expected to be irrecoverable. That provision which is determined with reasonable grounds to be irrecoverable is a provision which can be allowed as a deduction against the gross income for the relevant basis period.

6.2.1.1 The preparation of specific provision for doubtful debts

To make an estimation or a specific provision for doubtful debts, the likelihood of recovery of each debt has to be determined. This should be done at the end of the relevant accounting period (i.e. at or immediately after the time of closing the accounts).

The evidence regarding the following matters must be provided in preparing the specific provision for doubtful debts:

- a) that each debt has been evaluated separately;
- b) how the extent of its doubtfulness was evaluated;
- c) when and by whom this was done; and
- d) what specific information was used in arriving at that evaluation.

In addition to the items in the paragraph above, the circumstances below must also be considered for the purpose of evaluating a debt as doubtful:

- a) the period over which the debt has been outstanding;
- b) the current financial status of the debtor; and

- c) the credit record of the debtor.

For each doubtful debt, the specific proportion of the debt that is regarded as doubtful should be determined after taking into consideration the following:

- a) the person's history of bad debts,
- b) the experience for the particular trade /industry; and /or
- c) the age-analysis of the debts.

Subject to paragraph 6.2.1.2, the aggregate of the specific provision for each debt constitutes the specific provision for doubtful debts of the business which qualifies for deduction in that year.

6.2.1.2 Increase or decrease in the specific provision

Where a specific provision for doubtful debts has been made for a particular accounting period and the amount has been allowed in the relevant basis period for a particular YA, and there is a change in the amount of the specific provision in a subsequent year:

- a) a deduction should be made against the gross income for the subsequent year for the amount of the increase in the specific provision; or
- b) an addition should be made to the gross income for the subsequent year for the amount of the decrease in the specific provision.

Example 4

Delima Sdn. Bhd. made a specific provision for doubtful debts of RM3,500 for the financial year ended 30.6.2016. For the financial year ended 30.6.2017, the specific provision for doubtful debts was RM4,300. In its Income Statement, the

company showed the specific provision of RM3,500 for the year ended 30.6.2016 and the increase in specific provision of RM800 (RM4,300 - RM3,500) for the year ended 30.6.2017.

Provided that the conditions mentioned in paragraphs 6.2.1.1 has been met, the specific provisions made in the account are allowable for the relevant years and no adjustment is required in the tax computation.

Example 5

Elektra Sdn. Bhd. made a specific provision for doubtful debt of RM3,500 for the financial year ended 30.6.2016. For the financial year ended 30.6.2017, the specific provision was reduced to RM2,000 because some payments had been received.

The decrease in the specific provision of RM1,500 (RM3,500 - RM2,000) is shown as 'specific provision written back' in the Income Statement. No adjustment is required in the tax computation since the decrease in the specific provision of RM1,500 should be taxed.

6.2.2 General provision for doubtful debts

The general provision for doubtful debts is made without any separate evaluation for each debtor and is generally made based on a specific percentage of debtor balances, sales or any other general grounds. The general provision for doubtful debts is not allowed as a deduction since the provision is made based on general information, even if there is a legal requirement or an accounting convention for the particular trade or industry to make such a provision.

Any increase in the general provision is not allowable and any decrease, on the other hand, is not taxable.

An adjustment shall be made in the tax computation for any such general provision shown in the Income Statement.

- 6.3 Specific and general provisions do not alter the amount owing in the debtors accounts. On the other hand, a bad debt written off reduces the balance in relevant debtor's account.

Where a deduction has been made under subsection 34(2) of the ITA in ascertaining the adjusted income of a business, any sum which is recovered in a basis period shall be treated as gross income from the business for the relevant period – subsection 30(1) of the ITA.

7. Circumstances Where Irrecoverable Debts Are Not Allowed as Deductions

7.1 Forgiving or waiving payment of debt

A decision to forgive or to waive payment of a trade debt (either wholly or in part) should not be regarded as a valid business or commercial consideration for tax purposes. The amount written off for the above reasons shall not be allowed as a deduction against the gross income since the decision to write off such debt is not based on the possibility of recovery of the debt.

Example 6

Fuchsia Holdings Sdn. Bhd. is negotiating the take-over of one of its subsidiaries, Garnet Sdn. Bhd. by a consortium of businessmen. At the request of the consortium and in order to facilitate the deal, the directors of Fuchsia Holdings Sdn. Bhd. decide to forgive an accumulated debt on account of goods and services supplied to Garnet Sdn. Bhd. amounting to RM100,000. A letter to that effect (enclosing a copy of the directors' resolution) is issued to Garnet Sdn. Bhd. which then proceeds to extinguish the debt in its balance sheet as at 30.9.2017. In its accounts for the year ended 30.9.2017, Fuchsia Sdn. Bhd. writes off the amount as a bad debt.

In its tax computation for the relevant YA, Fuchsia Holdings Sdn. Bhd. should not be allowed a deduction for the amount written off as the decision is made for reasons other than in the ordinary course of business and on the basis of considerations other than the likelihood of recovery.

For Garnet Sdn. Bhd. the amount of debt forgiven should be reflected in its Income Statement where that amount which has been added back is taxable. The amount, being a reduction in the cost of goods and services previously charged in full in the Income Statement.

7.2 Non-trade debts

Non-trade debts that are written off as bad, or provisions made in respect of non-trade debts that are doubtful, either specific or general, are not deductible in the computation of adjusted income. Similarly, recoveries relating to non-trade debts written off earlier are not taxable. Suitable adjustments should be made in the tax computation if such amounts are included in the Income Statement.

7.3 Debt due from related or connected person

7.3.1 A stringent examination should be made before making a decision to write off (or to extinguish by any other means) a trade debt arising from a related or connected person as bad debts that can be considered for deduction for tax purposes. Similarly when making a specific provision for a trade debt due from a related or connected person, a stringent examination has to be conducted.

7.3.2 There should also be evidence to prove that the decision made to write off a trade debt is made at an arm's length basis and for valid business or commercial reasons. Strong evidence must show that the decision is not made based on private, personal or other non-commercial reasons.

Example 7

Herriot Holdings Sdn. Bhd. provides colour separation and other ancillary services to one of its subsidiaries, Jaya Printers Sdn. Bhd. Based on the draft accounts for the financial year ended 31.10.2017, Jaya Printers Sdn. Bhd. is expected to incur a substantial loss in respect of its printing business. To avert adverse publicity, the directors of Herriot Holdings Sdn. Bhd. (who are also directors of Jaya Printers Sdn. Bhd.) decided to waive payment of an amount of RM20,000 from the total amount owing by the subsidiary company on account of services rendered. Jaya Printers Sdn. Bhd. is informed of this by way of a letter and it proceeds to reflect this in its final accounts which show a small net profit. In the Income Statement of Herriot Holdings Sdn. Bhd. for the financial year ended 31.10.2017, the amount is written off as a 'trade discount'.

The amount written off should be disallowed in computing the adjusted business income of Herriot Holdings Sdn. Bhd. for the relevant YA

since there is no commercial basis for the 'discount' and the decision cannot in any way be regarded as being made at arm's length in view of the relationship of the two companies and the status of the directors.

No adjustment is necessary in the tax computation of Jaya Printers Sdn. Bhd. since the discount has been correctly treated for both accounting and tax purposes.

However, if this situation is between independent persons, the trade discount will be allowed tax deduction due to commercial reasons i.e. long term sustainability or joints brand name implications.

Example 8

Kamal, a sundry goods wholesaler, has been supplying goods on a regular basis to Latiff, a sundry shopkeeper, for the past 25 years. In the course of their long business relationship, they have become good friends. In 2008, Latiff married Kamal's sister. In the year 2013, Latiff's business has been steadily declining (amongst other reasons, due to the opening of a hypermarket in the vicinity) and in 2017, Kamal decided to write off the whole amount of the accumulated debts of Latiff (who is being sued by several of his other creditors).

In view of their relationship as brothers-in-law, the decision by Kamal to write off the debt of Latiff might be regarded as more for personal rather than for valid commercial reasons. Therefore, the trade debts that are written off should **not** be allowed as a deduction for tax purposes.

However, if it could be shown that the financial position of the debtor is the criterion for the decision (for example, Latiff has already been adjudged a bankrupt at the time the decision is made to write off the debt), then a deduction should be allowed since the write off is based on a valid commercial consideration.

Example 9

Matrix Bhd. writes off RM15,000 in its Income Statement for the year ended 31.7.2017, being the trade debt of its subsidiary Newton Sdn. Bhd., which has been liquidated and deregistered in the same period.

Since the trade debt is written off due entirely to the financial position of the debtor (the liquidation of Newton Sdn Bhd.), the amount written off should be allowed notwithstanding the relationship between the two companies.

8. Settlement of Trade Debt With Assets

A debt may be settled by the foreclosure of an asset held as security for the debt or by an asset (such as a property or shares in a company) given in exchange for the debt. In such a case, the net proceeds from the sale of the asset or the market value of the asset given in exchange is the value to be taken as settlement for the debt.

Any balance of the debt still outstanding can be claimed as a bad debt if one of the circumstances mentioned in paragraph 5.3.2 is satisfied.

Example 10

Tanah Development Sdn. Bhd., a property developer which has many unsold houses as its stock, owed RM300,000 to Spectrum Sdn. Bhd. a construction company. After some negotiation and in view of the severe cashflow problems of the debtor, Spectrum Sdn. Bhd. agrees to accept a completed shophouse (market value is at RM280,000) as full settlement of the debt. However, soon after the agreement is reached, the market for properties sharply weakens. On completion of the transfer, Spectrum Sdn. Bhd. decided not to sell the shophouse immediately. Instead, the shophouse is let out. In the transfer documents for the property, the consideration is shown as RM280,000 and stamp duty based upon that value is duly assessed and paid. In its Income Statement, Spectrum Sdn. Bhd. has written off RM20,000 (RM300,000 - RM280,000) as a bad debt after one of the circumstances mentioned in paragraph 5.3.2 is satisfied.

The write off amounting to RM20,000 should be allowed for tax purposes as the market value of the asset accepted in exchange for the debt is RM280,000, as evidenced by its acceptance by the Collector of Stamp Duty.

9. Updates and Amendments

This PR replaces PR No. 1/2002 dated 2 April 2002.



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10. Disclaimer

The examples in this PR are for illustration purposes only and are not exhaustive.

**Director General of Inland Revenue,
Inland Revenue Board of Malaysia**