

Consumer Taxes

TVQ. 444-1/R2 **Bad debts**
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Reference(s): *An Act respecting the Québec sales tax (R.Q.S., c. T-0.1), ss. 444, 446, 446.1, 448 and 449*

This version of bulletin TVQ. 444-1 supersedes the version of March 31, 2004.

The bulletin was revised to provide certain particulars as to when a debt becomes a bad debt for the purposes of section 444 of the Act respecting the Québec sales tax. In addition, some style changes were made for the purposes of consistency and clarity.

The bulletin has effect from July 1, 1992, except for the points that concern mandataries who are registrants and with whom a supplier has made a joint election pursuant to section 41.0.1 of the Act respecting the Québec sales tax. Those points have effect in respect of supplies made after April 23, 1996. Furthermore, the bulletin is subject to the adoption of legislation by the National Assembly of Québec to implement the measures concerning the rules respecting bad debts which were announced by the Minister of Finance of Québec in the Budget Speech of June 12, 2003.

This bulletin clarifies the application of sections 444 and 446 of the *Act respecting the Québec sales tax (AQST)* with respect to bad debts.

APPLICATION OF THE ACT

1. Under sections 444 and 446.1 of the AQST, where all or part of the consideration and tax payable in respect of a taxable supply is written off in a supplier's books of account, the supplier may claim a deduction in determining the net tax related to the debt written off. The deduction is allowed provided the supplier

- made a taxable supply, other than a zero-rated supply, to a recipient with whom the supplier was dealing at arm's length;
- indicated the tax collectible in respect of the supply in the supplier's return filed for the reporting period during which the tax became collectible;

- remitted all net tax remittable as reported in that return; and
- made the adjustment in determining the net tax within four years after the filing-due date of the return covering the reporting period during which the bad debt was written off.

2. If all those conditions are met, the amount that may be deducted by the supplier in determining the net tax is determined by the formula

$$A \times B/C$$

where

A is the QST payable in respect of the supply;

B is the total of the consideration (including GST) and QST remaining unpaid in respect of the supply that was written off as a bad debt; and

C is the total of the consideration (including GST) and QST payable in respect of the supply.

3. In news release 2002-108 of December 20, 2002, the Minister of Finance of Canada made public proposed amendments respecting bad debts. In subsection 5 of section 1 of the *Additional Information on the Budgetary Measures* of March 11, 2003, the Minister of Finance of Québec made announcements relating to legislation and regulations concerning the harmonization of the QST system with the proposed federal amendments, and those announcements were maintained in the Budget Speech of June 2003. In accordance therewith, a supplier's mandatary who is a registrant may claim a deduction in determining the net tax related to a debt written off in the books of account of the supplier represented by the mandatary, provided the mandatary and the supplier have made a joint election under section 41.0.1 of the AQST and all the conditions under sections 444 and 446.1 of the AQST are met. These measures apply to supplies made after April 23, 1996.

THE CONCEPT OF "BAD DEBT"

4. "Bad debt" is not defined in the AQST. However, certain criteria established for the purposes of tax on income, as well as a review of generally accepted accounting principles, may be useful in interpreting this expression for the purposes of QST.

5. Whether a debt is bad is a question of fact to be determined by considering the relevant circumstances of each case. However, the following factors may be taken into account in making that determination:

- the period of time elapsed since the due date for payment of the debt;
- the debtor's financial condition;
- the debtor's account history; and
- the cost of recovery action versus the amount of the debt.

6. To benefit from the bad debt adjustment under section 444 of the AQST, the bad debt must be written off in the supplier's books of account. Moreover, the supplier must establish, to the Minister's satisfaction, that all reasonable steps have been taken in an attempt to recover the debt.

7. While legal proceedings brought by a supplier to recover an outstanding debt are pending, there is generally no reason to consider that the debt is bad. Indeed, there is a likelihood that the supplier will recover the debt at the end of the proceedings. Ultimately, the facts and circumstances will determine whether all or part of the debt is a bad debt for the purposes of section 444 of the AQST.

8. Where only part of the consideration and tax is written off as a bad debt, an amount equal to a proportionate part of the amount written off may be deducted under section 444 of the AQST, whether the amount written off is part of the consideration, part of the tax or part of both.

Example

9. A supplier receives an \$800 deposit on a \$1,139.50 sale. The latter amount includes \$60 in GST and \$79.50 in QST. The unpaid balance of \$339.50 becomes a bad debt. It is therefore written off as such in the supplier's books of account. By making a tax adjustment, the supplier can then recover \$23.69 of QST, determined as follows:

$$\$79.50 \times \$339.50 / \$1,139.50 = \$23.69.$$

PROPOSAL OR ARRANGEMENT

10. A bad debt that is written off may sometimes result from a proposal made by the debtor. Among other things, such a proposal makes it possible to enter into an agreement enabling the debtor to improve its financial condition and avoid bankruptcy. If the proposal is accepted by the debtor's creditors, section 444 of the AQST applies to the debts or parts of debts written off pursuant to the proposal, provided all the prescribed conditions are met.

11. Moreover, a debt that is written off may also result from an application made by a debtor for the purpose of ensuring the continuity of the debtor's business. Such an application, subject to the control of the court, allows an arrangement to be made under the *Companies' Creditors Arrangement Act* (R.S.C., 1985, c. C-36). Section 444 of the AQST applies to the debts or parts of debts written off under such an arrangement, provided all the prescribed conditions are met.

REDUCTION OF CONSIDERATION

12. In certain cases, such as debt forgiveness, a supplier may forgive all or part of a debt by voluntarily reducing the consideration for a supply or by entering into an agreement to that effect with the debtor.

Example

13. Six months after work is completed, X Construction Corporation, further to an agreement with a customer, forgives \$30,000 of a total debt of \$100,000, since the customer is in financial difficulty.

14. In this example, section 444 of the AQST does not apply, because the debt forgiveness constitutes a reduction of the consideration and cannot be considered a bad debt written off according to the above-mentioned criteria.

15. However, a supplier may be entitled to a reduction in net tax if section 448 of the AQST applies. Pursuant to that section, where a particular person has charged to, or collected from, another person tax on the consideration or a part thereof for a supply and, for any reason, the consideration or part is subsequently reduced, the particular person may, in the reporting period of the particular person in which the consideration was so reduced or within four years after the end of that period,

- (a) where the tax calculated on the consideration or part was charged but not collected, adjust the amount of tax charged by subtracting the portion of the tax that was calculated on the amount by which the consideration or part was so reduced; and
- (b) where the tax calculated on the consideration or part was collected, refund or credit to that other person the portion of the tax that was calculated on the amount by which the consideration or part was so reduced.

16. Finally, paragraph 1 of section 449 of the AQST specifies that, where a person has adjusted, refunded or credited an amount in favour of, or to, another person in accordance with section 448 of the AQST, the particular person must, within a reasonable time, issue to the other person a credit note, containing prescribed information, for the amount of the adjustment, refund or credit, unless the other person issues a debit note, containing prescribed information, for the amount. In determining the net tax, the other person, who receives a credit note or issues a debit note, must add the amount of tax credited or refunded, to the extent that the amount has already been included in determining an input tax refund.

RECEIVER AND TRUSTEE

17. Provided all the conditions set out in point 1 of this bulletin are met, a receiver or a trustee may, as the mandatary of the bankrupt, take advantage of the adjustment under section 444 of the AQST. However, where such an adjustment gives rise to a tax refund, the refund will not be made until all the returns have been filed for the periods that ended before the bankruptcy or receivership and all the amounts due for those periods have been paid to the Minister of Revenue.

RECOVERY OF A BAD DEBT

18. Pursuant to section 446 of the AQST, where a supplier recovers all or part of a bad debt in respect of which the supplier (or the mandatary who is a registrant and with whom the supplier has made a joint election under section 41.0.1 of the AQST) has made a deduction under section 444 of the AQST, the supplier (or the mandatary), in determining the net tax for the reporting period during which the bad debt or that part was recovered, is required to add the amount determined by the formula

$$A \times B/C$$

where

A is the amount recovered;

B is the tax payable in respect of the supply to which the bad debt relates; and

C is the total of the consideration (including GST) and QST payable in respect of the supply.

Example

19. A supplier makes a sale. The consideration is \$1,000, to which \$60 in GST and \$79.50 in QST are added, for a total of \$1,139.50. The total amount becomes uncollectible. It is therefore written off as a bad debt in the supplier's books of account, and the supplier makes the adjustment under section 444 of the AQST. Three months after the write-off, the supplier receives a \$500 payment towards the debt. In determining the net tax, the supplier must add \$34.88 for QST, determined as follows:

$$\$500 \times \$79.50 / \$1,139.50 = \$34.88.$$

20. The adjustment must be made in the reporting period during which the part of the debt is recovered.