LEGAL ARTICLE

You have reached the point where the customer seems to have a good faith to repay the bills under the settlement agreement. How exactly the debt settlement works? What should we note during the period of negotiation and settlement? What if the customer still won't pay? This article provides guidance on legal aspects of the debt settlement and its tax-related implications.

DEBT SETTLEMENT & TAX CONSEQUENCE

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Dealing with debt collection is not the task that many in corporate are so eager to do. But debt collection is an inevitable task that someone in a company has to do, otherwise some accounts receivable may never be recovered.

Whenever any customer fails to pay a bill for any goods delivered or any services performed by a company, the company may initially attempt to follow up the unpaid amount by itself with a phone call, a demand notice, or a threat to suspend the remaining delivery of goods or performance of services. At a later stage, legal professionals may be engaged to assist the company to pursue any unpaid bill.

A customer does not pay the bill on time for various reasons. In certain circumstances, the customer may be willing to pay an outstanding amount, but comes up with one or more conditions as follows:

1. By Installments

The customer cannot afford to pay the outstanding all at once, but is willing to pay the bill to the company over a specified period of time by instalments.

2. Postponement

The customer cannot afford to pay the bill right away and asks for the postponement of the payment up to the specified date.

3. Waiving Disputed Amount

The customer challenges a portion of the billed amount for any defects or any other reason and is willing to pay the remaining amount under the condition that the disputed amount of the bill is waived by the company.

4. Free of Charge Replacement

The customer will pay the bill only after the company agrees to supply any other goods or services to the customer free of charge.

5. Defect Rectification

The customer requires the company to rectify any defects in goods or services prior to the payment of the bill.

Importance of Settlement Agreement

In any of the aforementioned circumstances, the company is recommended to enter into a settlement agreement to record the agreed terms between the company and the customer.

Law provides that a settlement agreement is not enforceable by action unless there be some written evidence signed by the party liable to or his agent. This means the verbal settlement agreement cannot be relied upon in the court.

What if the customer still fails to pay any agreed amount under the settlement agreement to the company?

In the event that the customer still fails to pay any agreed amount under the settlement agreement, the settlement agreement may be perceived as useless and the company will have to file a lawsuit to a court to recover an outstanding amount as set forth by the settlement agreement from the customer. But legally speaking, the settlement agreement makes the company's claim against the customer stronger (higher merit) and in practice significantly minimizes the company's burden of proof because the company no longer has to prove that the customer owes the specified amount to the company - all of these favourable factors will improve the company's chance of winning the case.

In-Court Settlement Agreement

When the company files a lawsuit to the court to recover an unpaid bill from the customer for the goods delivered or the services performed, in some cases the company and the customer may agree to enter into the settlement agreement before the court, which is also known as the in-court settlement agreement. After the execution of the in-court settlement agreement, the court will give the decision according to the settlement agreement.

This in-court settlement agreement is different from the regular settlement agreement executed outside a courtroom by the parties. Once both parties enter into the in-court settlement agreement and the court gives the judgment according to the settlement agreement, the customer's failure to pay any agreed amount under the in-court settlement agreement will entitle the company to enforce the in-court settlement agreement against the assets of the customer right away through the Legal Execution Department.

In most cases, the customer's failure to pay any amount under the in-court settlement agreement will entitle the company to proceed with the enforcement of the in-court settlement agreement based on the amount in the original claim in the company's lawsuit, not the agreed amount under the in-court settlement agreement.

Tax Consequence of the Released/Reduced Amount under the Settlement

Regardless of whether it is the regular settlement agreement or the in-court settlement agreement, in the process of negotiation for the settlement the customer might demand that the company partially release or reduce the claimed amount as a condition for entering into the settlement agreement.

For instance, the company follows up the claim of Baht 100 Mil for the sale price of the delivered goods with the customer, but the customer agrees to pay only Baht 95 Mil. If the company agrees to release or reduce Baht 5 Mil for the customer, a tax question that typically arises is: what happens with the tax deductibility of Baht 5 Mill that the company agrees to release or reduce for the customer?

The answer is not so favorable to the company that releases or reduces the portion of the debt for the customer. One revenue ruling indicates that the released/reduced amount that the company gives to the customer under the in-court settlement agreement cannot be booked as a deductible expense for a purpose of a computation of the company's net profit because it does not fulfil the conditions laid out by the Ministerial Regulations issued by virtue of the Revenue Code.

Generally, the Ministerial Regulations will require the company to first file a lawsuit against the customer and win the case. Only after the company has attempted to enforce the winning judgment against the customer's assets and the official of the Legal Execution Department has confirmed that the customer does not have any assets to be enforced (and put up for the public auction) to pay the debt to the company, then the company may book the bad debt as the deductible expense under the Revenue Code.

In conclusion, if the company agrees to release or reduce any amount of the bill for the delivered goods or the performed services under the settlement agreement to get the customer to pay the remaining amount regardless of whether the settlement agreement is executed in or outside a courtroom, the released/reduced amount cannot be booked a deductible expense of the company in a computation of its net profit under the Revenue Code. (Hint: It should be booked as deductible expense.)

Alternative Option to Writing off Bad Debt

Given the Ministerial Regulations make it difficult, if not impossible, for the company to book the bad debt as the deductible expense in a computation of a net profit, to get around these tough conditions, some companies may prefer to sell the bad debt at a fraction of the full value (at a loss) to any third party (i.e. financial institution).

By selling the bad debt at a loss to any third party, the company may wish to book the loss from selling the bad debt as the deductible expense in a computation of the net profit under the Revenue Code. For instance, for the full value of bad debt of Baht 100 Mil, the company may sell at Baht 30 Mil to a third party.

However, there are the two main obstacles to this method.

1. The Market Price of Bad Debt

The bad debt must be sold at the market price, not lower, otherwise the assessment officer of the Revenue Department has the right to assess the market price of the sold bad debt and include the additionally assessed income as the income of the company for a purpose of a computation of the net profit.

It is quite difficult to come up with a reasonable market valuation of the bad debt that may never been recovered. Obviously, the company must attempt to sell the bad debt at the price as high as possible insofar as there is a willing buyer.

In many cases, there are a few willing buyers or no willing buyer. If the buyer wants to buy the bad debt at 30% or 40% of the full value, the company may have to accept the price and consider 30% or 40% of the full value as the market price. However, the assessment officer may have a different opinion of the market price of the bad debt sold. The assessment officer could challenge that 30% or 40% of the full value of the bad debt is way below the market price of the bad debt.

In the Supreme Court Decision no. 5656/2536, the company sold both good accounts receivable and bad accounts receivable to the shareholder in an internal corporate restructure at 85% of the full value of both good accounts receivable and bad accounts receivable. It was still uncertain whether the transferee would ultimately receive the full value of the accounts receivable or not. 15% discount was given to make some provisions for the bad accounts receivable that the transferee may never receive the payment or the transferee may have to sue to recover the payment, which would incur additional expenses. The 15% discount was based on the multiyear statistic on recovery of accounts receivable of the transferor.

Again, the assessment officer was still not convinced with the multiyear statistic on recovery of account receivable and went ahead to assess the market price of the accounts receivable at the higher price. The transferor company filed an appeal against the assessment of the assessment office to the Appellate Committee, which still ruled in favor of the assessment officer. So the transferor company filed a lawsuit against the Revenue Department. This case had to go all the way to the Supreme Court before the Supreme Court ruled that 85% of the full value of the accounts receivable was the market price.

Event if in this case the taxpayer eventually prevailed over the assessment officer, but it was a tiring and time consuming process. And this kind of argument over the market price of the bad debt can arise at any time because there is no generally acceptable formula to come up with the valuation. Of course, you could theoretically use a present value of future cash flows. But the discount rate and when the debt is expected to be repaid in the legal proceeding are difficult to accurately determine.

2. Non-deductibility of The Loss Derived from Sale of Bad Debt

In one revenue ruling, the company provided the services to the customer, but the customer could not pay back the services fee to the company. So company allowed the customer to convert this trade debt (services fee) into the loan and the shares in the customer. Eventually, the company sold the loan at 33% of the cost (at a loss).

The Revenue Department ruled the loss (100% – 33% = 77%) derived from the sale of the loan was the nondeductible expense on the ground that it was the expenses not exclusively expended for the purpose of acquiring the profits or for the purpose of business because the loan was converted from the trade debt. assistance).

Therefore, dealing with the unfavorable tax consequence of writing off bad debt under the Revenue Code is far from straightforward. If the company does not like the idea of suing the customer to recover the debt and waiting until the official at the Legal Execution Department confirms that the customer does not have any assets to pay back the debt, the sale of the doubtful or bad debt must be done with care.

challenge that the sale price is lower than market price. The problem here is the difficulty in formulating an acceptable valuation method for the market price of bad debt. Moreover, the assessment officer may construe that the loss derived from the sale of the debt is a non-deductible expense on the ground that it is the expense not exclusively expended for the purpose of acquiring profits or for the purpose of business.

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