Corporate income tax treatment of security deposits (2/29/20)

The Corporate Income Tax ("CIT") Act prescribes a 12-month time limit, within which a prepayment does not become a deemed profit distribution. This article explores whether the landlord's tax base should include a security deposit that was received when entering into a tenancy agreement and will be refunded at the end of the tenancy.

Non-business expenses

Section 8(2)(2) of the CIT Act provides that non-business expenses comprise all expenses that are not directly related to the taxpayer's business, including a reduction in profit, revenue or other baseline amount the taxpayer makes on their own initiative or according to a shareholder's instructions.

Neither the CIT Act nor the explanatory rules initially defined expenses covered by this provision.

On 30 January 2020, the CIT Act was amended (effective from 12 February 2020) to supplement section 8 with subsection 2.1(1), which provides that if the transaction does not begin within 12 months after the month in which the prepayment or deposit was made, this should be included in the tax base for the last month of the financial year. So the economic substance of the prepayment changes in 12 months' time if the recipient of the prepayment has failed to supply the goods or services. If the transaction then takes place within 36 months after the prepayment, the taxpayer may adjust the tax return for the tax period to reduce the amount included in the tax base.

Please note that this provision has been adopted to prevent any artificial removal of profits from the company. Since non-business expenses for CIT purposes are determined according to the transaction's economic substance and legal form, each situation should be assessed on its own merits.

If the tenancy agreement provides for a deposit payable to secure performance of the tenant's obligations and the space is actually leased (the service is supplied), the deposit is not a taxable item for the landlord and should be excluded from the tax base.