How to utilise old profits free of corporate tax (1/39/20)

Companies having large pre-2018 retained earnings available for distribution in dividends free of corporate income tax (“CIT”) are at an advantage because CIT costs can be reduced not only on profit distribution but also in other cases. This article explores some additional ways of utilising the “old” profits and mentions a few points to consider.

Provisions of the CIT Act

When looking at companies that still have profits accumulated before 2018, the first option that comes to mind is distributing them in dividends free of CIT. This is certainly a good and fair approach, as CIT on this portion of profits has already been paid under the old regime.

If the company made a loss in 2018 or later, that loss will reduce the old profits available for distribution free of CIT. To utilise the remaining profits, the company has the following alternatives:

1. writing off debts on the balance sheet at 31 December 2017;
2. lending to a related party on the condition specified by paragraph 34 of the transition rules of the CIT Act to avoid having to pay tax (i.e. the loan does not exceed the retained earnings on the balance sheet at 31 December 2017).

So the company’s retained earnings is like an asset that can be used in several ways, always observing the sequence prescribed by paragraph 10 of the transition rules of the CIT Act:

Any receivables on the balance sheet at 31 December 2017 that can be written off under section 9(3) of the CIT Act will reduce taxable income (using a coefficient of 0.75) on line 21 of the CIT return. These sorts of write-offs will reduce the old retained earnings if the company did not make a provision for doubtful debts before 2018 (i.e. it did not pay CIT under the old regime).

If a loan is made to a related party free of CIT, while the profits available for distribution free of CIT are reduced, the loan repayment will again increase the retained earnings for CIT purposes.

An issue

In practice we have come across this issue: if a company is to deduct receivables arising before 2018 from taxable income, it must have some taxable income.

If the company historically had a large bad debt but its monthly CIT charges on non-business costs are small, the company might be unable to take CIT relief when writing off that debt. If relief is not taken, the profits available for distribution free of CIT do not need reducing.

If the company expects to have a larger taxable base once the profits arising after 2017 are distributed, then taking CIT relief can be restricted by the requirement that the FIFO (“first in, first out”) principle be applied to the profit distribution, i.e. the old profit should be distributed first.

To illustrate what happens, we will use an example offering data of a case-study company:

Retained earnings at 31.12.2019	EUR 1,000,000*	**This includes 500k of retained earnings at 31.12.2017.*
Old debts (before 2018) written off as losses	EUR 400,000*	**The taxable base can be reduced by up to 300k because of the applicable coefficient of 0.75.*
Taxable base in December 2020 arising from thin capitalisation and non-business expenses	EUR 200,000	

Below are three options whereby the retained earnings at 31.12.2017 are not distributed, are distributed partially, or are distributed in full in 2020, and the scope for deducting receivables from the taxable base in December 2020:

Option A	Option B	Option C
Retained earnings are not distributed: • EUR 200k can be deducted from the taxable base through the debt write-off, while the old profit available for distribution free of CIT is reduced on the CIT return. • EUR 300k of the old profit is still available. • CIT cost: EUR 0	Shareholders decide to distribute EUR 300k in dividends: • EUR 200k can be deducted from the taxable base through the debt write-off, while distributing the old profit free of CIT. • The old profit is not available because it has all been used up (EUR 300k in dividends and EUR 200k for writing off the old debt). • CIT cost: EUR 0	Shareholders decide to distribute EUR 500k in dividends: • EUR 200k cannot be deducted from the taxable base because the old profit has all been used up for distribution free of CIT. • The old profit is no longer available. • CIT cost: EUR 50k