New CIT Act: bad debts (2/38/17)

In this article we explore the subject of bad debts.

The tax base

A bad debt is taxable under section 9 of the new CIT Act if –

- a provision has been made for it and expensed to the profit and loss account (P&L), and the debt remains unrecovered 36 months after that provision was made, or it does not qualify for an exemption; or
- the debt has been taken to P&L without making a provision for it earlier, and an exemption is not available.

It is important for companies to have a provisioning control mechanism in place for monitoring the 36-month period.

As before, bad debt provisions or their write-offs in banks as well as savings and loan associations, made according to IFRS[1] or the Financial and Capital Market Commission’s requirements, and bad debt provisions in the financial institution for development, are exempt from CIT.

Exemptions

A bad debt exemption is available if –

- all reasonable steps have been taken to recover the debt,
- the debtor is resident in an EU/EEA member state or in a country that has an effective double tax treaty with Latvia, and
- one of the following conditions is met:

Debtor – an entity	Debtor – an individual
The debtor is a central- or local-government company that has been liquidated.	There is a court order to collect the debt from the debtor and a bailiff’s finding that collection is not possible.
There is a court order to collect the debt from the debtor and a bailiff’s finding that collection is not possible, and the entity has been removed from the Latvian Enterprise Register or from a register kept by another EU/EEA member state or by a country that has an effective double tax treaty with Latvia.	The debtor is not a related person to the company that forgives him a loan, and the forgiven amount does not attract personal income tax under section 9 of the Personal Income Tax Act.
The debt is lower than its recovery expenses, capped at EUR 20.	
Seeking recovery through the courts is deemed impracticable because the debt is lower than its recovery expenses, provided all reasonable steps have been taken to recover it, and the debt does not exceed 0.2% of the taxpayer’s net revenue for the financial year, or EUR 500, whichever is lower.	
The court has ruled that the debt matches a proportion by which the principal debt, contractual penalty or interest is forgiven or reduced according to an action plan being carried out as part of the debtor’s legal protection proceedings in court or out of court.	
The debt is recognised according to the register of creditor claims once the court has confirmed completion of the debtor’s –	

a) insolvency procedure (in the case of a company, partnership, or sole trader).	b) bankruptcy procedure (in the case of an individual).
The debt remains unrecovered from a debtor whose business has been suspended by decision of the tax authority, and the debtor has been removed from the Latvian Enterprise Register.	The debtor is dead.

While most of the criteria match those listed in the current law, the new law introduces a number of new criteria when written off debts are deductible for CIT purposes, including these:

- Caps are put on how much debt can be written off for reasons of impracticability and disproportionate cost (€20 and €500). These will now apply to debts incurred by entities as well as individuals;
- The debt remains unrecovered from a debtor whose business has been suspended by decision of the tax authority, and the debtor has been removed from the Latvian Enterprise Register;
- The debtor is dead.

It is important to note that these rules do not cover loans to related parties included in the tax base.

As before, any VAT included in a debt will be exempt from CIT as long as that VAT has not been deducted from output VAT, and the tax base can be reduced by –

- any recovered amount of debt that was expensed or had a special provision included in the tax base in any tax period of past years;
- an amount of debt or a reduced amount of special provision that qualifies for an exemption, provided the amount was included in the tax base in a past period.

All these rules apply to debts booked on or after 1 January 2018.

Transition rules

Any debts appearing on the balance sheet as at 31 December 2017 can be deducted from the tax base after applying a coefficient of 0.75 where an exemption is available if –

1. the debt will expensed to P&L. In that case the amount will be deducted from exempt retained earnings appearing on the balance sheet as at 31 December 2017. As mentioned earlier, companies will be allowed to distribute their profits earned before 2018 without applying the new CIT regime;
2. a bad debt provision recorded separately from other provisions will be reduced.

---

[1]International Financial Reporting Standards