

# Adjusting VAT on bad debt: options and obligations

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On 10 May 2021 the State Revenue Service ("SRS") posted on their website an update to "Bad Debts" offering guidance on how VAT and corporate income tax should be applied. This article explores the VAT treatment of debt assignment.

### The legal framework

**Section 105 of the VAT Act** permits the taxable person to deduct the input tax paid on the bad debt from the output tax paid to the government if the statutory conditions are met. One of the conditions for bad debts of up to EUR 430 and more is that the receivable has not been transferred (assigned) to a third party.

While neither **the VAT Act** nor the Cabinet of Ministers' rules clearly provide that adjusting VAT on a bad debt permits it to be assigned at a later date, nor do they specify the VAT implications for the supplier of goods (services) or the customer, the guidance implies that the SRS accepts that a taxable person having adjusted VAT on a bad debt may later assign it. The right to the VAT adjustment remains only to the extent the assignee fails to recover the debt.

**The SRS guidance (examples 17 and 18)** lays down procedures for readjusting VAT on the assignment of receivables that have been VAT-adjusted for bad debts earlier. The SRS states that an assignment fee paid to the assignor does not affect the bad-debt adjustment but readjustments should be made according to amounts the assignee recovers. The SRS offers an example involving the assignment of a receivable worth EUR 100 (including EUR 17.35 of input tax the supplier recovered as a bad-debt adjustment from the government), and no VAT adjustment is required on receipt of an assignment fee equal to 10% of the receivable (i.e. EUR 10). But if the assignee recovers any part or, in this example, the full receivable of EUR 100, the assignor is liable to pay VAT on the recovered debt to the government (EUR 17.35 in the example). This represents an amount the assignor has not received and will never receive. And the guidance emphasises that when entering into a contract for debt assignment, the parties have to ensure that information will be received from the assignee on fully or partly recovered receivables transferred to him in order to enable the assignor to calculate and pay VAT on those to the government.

From a tax revenue perspective, we can understand this SRS position because once the debtor repays his debt, he again obtains the right to report input tax on the debt repaid (the VAT on the outstanding debt refunded to the government earlier on receipt of the supplier's notice). However, the obligation to monitor amounts the assignee recovers is not practicable. This would mean that contracts for debt assignment should include a condition requiring the assignee to notify the assignor of all recovered amounts of debt. And from the supplier's viewpoint, he has to pay to the government an amount of VAT he has not received and will never receive. This practice is contrary to the principle of VAT neutrality.

**Council Directive 2006/112/EC** permits each member state to decide on how this right is exercised where input tax is adjusted on transactions that remain fully or partly unpaid. For example, Lithuanian and Estonian laws provide for adjusting VAT on bad debts with restricted adjustment in the case of an assignment. Yet the Estonian legislation does not require monitoring the level of debt recovered by the assignee, but rather provides that where a VAT-adjusted debt is assigned, the relevant amount of VAT must be refunded to the government. We believe this solution makes sense.

