

Corporate tax treatment of prepayments 2/32/21



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We have written before about how the new CIT Act treats prepayments for goods or services. This article explores differences in this treatment depending on when payment is made, and suggests steps to take after a bad debt is written off.

The legal framework

Under section 8(2.1)(1) of the CIT Act, if a transaction has not started within 12 months after the month of prepayment, this must be included in the tax base when preparing the tax return for the last month of the financial year.

The period of limitation during which the tax return for the tax period can be adjusted to reduce the payment included in the tax base if the goods or services are received, is 36 months after the month of prepayment.

This CIT provision has been in force since 12 February 2020. Neither the transitional provisions of the CIT Act nor the annotation to the amendments state that this provision merely clarifies the Act and applies retrospectively. Accordingly, the provision of the CIT Act for the treatment of prepayments applies to those made after 11 February 2020.

In applying section 8(2.1)(1) of the CIT Act, we need to assess the circumstances of the outstanding goods or services. If we can provide economic grounds for those circumstances and show that the prepayment was made for any purpose other than to artificially remove profits, the prepayment can escape CIT subject to approval from the State Revenue Service.

Background and tax treatment

The table below analyses three situations involving one scenario but the timing of prepayment is different. This factor plays a decisive role in determining the principles of CIT treatment for prepayments and should be evaluated for the tax implications of a bad debt write-off.

Timing of prepayment	Background	Tax treatment of prepayment	Steps after the bad debt write-off
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Before 2018			<p>A receivable arising before 2018 is an “old” debt. Tax implications: no additional CIT to pay.</p> <p>To establish the scope for reducing the tax base, we need to answer two questions:</p> <p>1) Has a provision been made for the debt and when was it made?</p> <p>2) Are the conditions of section 9(3) of the CIT Act satisfied?*</p>
Period from 1 January 2018 to 11 February 2020 (inclusive)	<p>A prepayment has been made but the services are outstanding, so the balance sheet shows a receivable.</p> <p>Management understands that the services will not be received in future periods and the prepayment cannot be recovered.</p>	<p>Section 8(2.1)(1) of the CIT Act does not apply.</p>	<p>A receivable arising after 2017 is a “new” debt. Tax implications: a CIT charge may arise. We need to evaluate the conditions of section 9(3) of the CIT Act. If they are not satisfied, the debt must be included in the tax base when preparing the tax return for the last month of the financial year.*</p>
Period beginning 12 February 2020	<p>The decision is made to write off the bad debt.</p>	<p>Section 8(2.1)(1) of the CIT Act applies.</p>	<p>In assessing the CIT implications of the bad debt write-off, we need to answer two questions:</p> <p>1) Was the debt included in the tax base (since the services were not received within the 12-month period, the company was required to include the prepayment in the tax base as a non-business expense)?</p> <p>2) Are the conditions of section 9(3) of the CIT Act satisfied?</p> <p>Tax implications: If the prepayment was included in the tax base, it should not be taxed again as a receivable, yet the CIT Act does not lay down special rules for this situation. If the conditions of section 9(3) of the CIT Act are satisfied, the tax base can be reduced under section 9(5) of the CIT Act.*</p>

* The CIT treatment of receivables is detailed in our [article of 11 May 2021](#).