TAX REFORM IN LATVIA

Changes from January 1, 2018

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US TAX REFORM

President Trump signed the "Tax Cuts and Jobs Act" into law on Dec. 22.

The law cuts corporate tax rates permanently and individual tax rates temporarily.

The changes will be temporary, going into effect in 2018 and expiring after 2025

US – TAX REFORM

Tax rates

	Current	New
Corporations	15, 25, 34, 35	21 %, Combined with state and local taxes, the statutory rate under the new law will be 26.5%
Individuals	10, 15, 25, 28, 33, 35, and 39.6. Capital gain 0, 15, and 20.	10,12, 22, 24, 32, 35, and 37. Capital gain rates are 0, 15, and 20.
Standard deduction for individuals:	$6500, 9550, 13000	$12000, $18000, 24000.

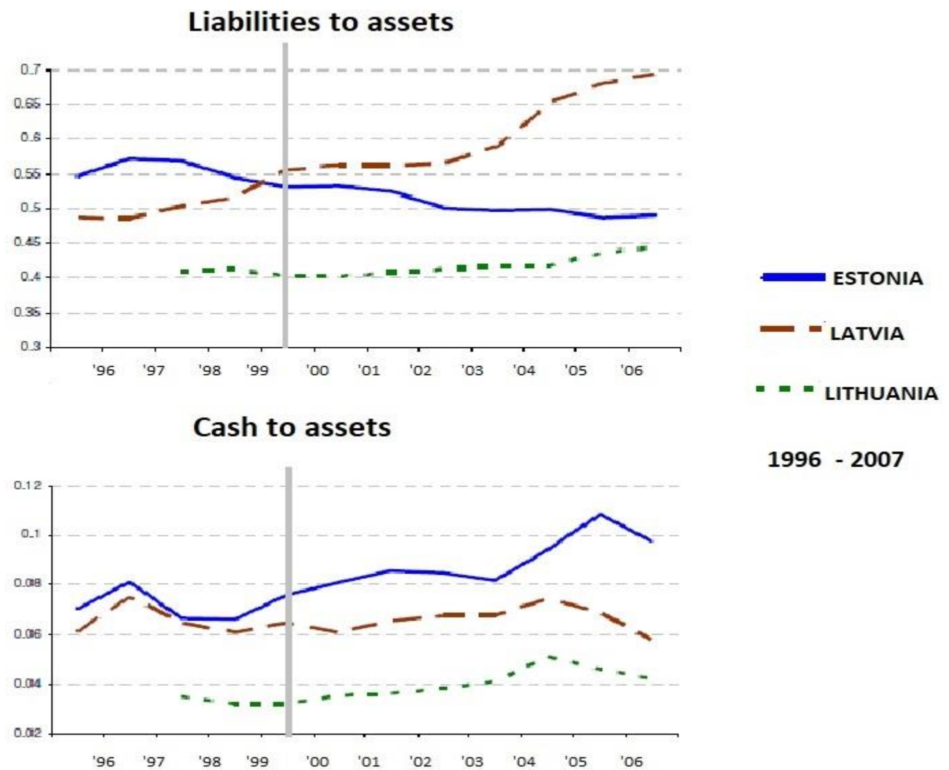
CIT 2018 AS THE CASH-FLOW TAX

NEW CIT = CASH FLOW TAX

Changes in the capital structure

- **Less reliance on debt financing instruments *vs* higher reliance on internal financing sources**

  (decreased debt/equity ratio)
- **Improvement of liquidity**
- **Better recovery from the financial crisis**
- **Increase in retained earnings and capital reserves**
- **Positive effect on the capital structure of SME’s**



Source: Jaan Masso, Jaanika Meriküll, Priit Vahter, Gross Profit Taxation Versus Distributed Profit Taxation and Firm Performance: Effects of Estonia’s Corporate Income Tax Reform, 2011

INTRODUCTION OF THE CASH-FLOW TAX SYSTEM

Impact factors *vs* Challenges

Impact factors*	Challenges
• Increase in income from CIT collection • Less opportunities to implement harmful tax planning and profit shifting structures • Decrease of the impact of tax distortions on the investors decision-making • Simplification of the CIT system structure by reducing number of CIT adjustments	• Complex transition period and grandfathering clauses • Decrease in income from CIT collection in the first years of the system introduction • More complicated accounting on the monthly basis and monthly tax payments • Discrepancies of the tax system harmonization with the provisions of the iinternational tax treaties and directives • The reinvestment of the capital results in the higher tax burden upon the profit repatriation by foreign investors** • Failure to achieve neutrality with respect to the financial and investment decisions by simultaneously continuing to yield budget revenue form past investments

** OECD Tax Policy Studies, Fundamental Reform of Corporate Income Tax No.16*
***Seppo Kari & Jouko Ylä-Liedenpohja, Cost of Capital for Cross-Border Investment: The Fallacy of Estonia as a Tax Haven, Baltic Journal of Economics, 2005*

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LATVIA - ESTONIA

	LATVIA	ESTONIA
TAX	CIT, PIT	INCOME TAX
RATE	20/80 on net amount 20 % from gross amount	20/80 or 14/86 (2018) on net amount, 20 % or 14% (2018) from gross amount 7% additionally for individuals
Payment to non - resident	**Withholding tax:** • 20 % on income from management and consultancy services; • 3% on income from alienation of immovable property • 20 % on any payment to «offshore» countries	**Income tax on income:** • 20% on income from alienation of immovable property (difference between the acquisition cost and the selling price of the sold property) • 20 % on any payment to «offshore» countries

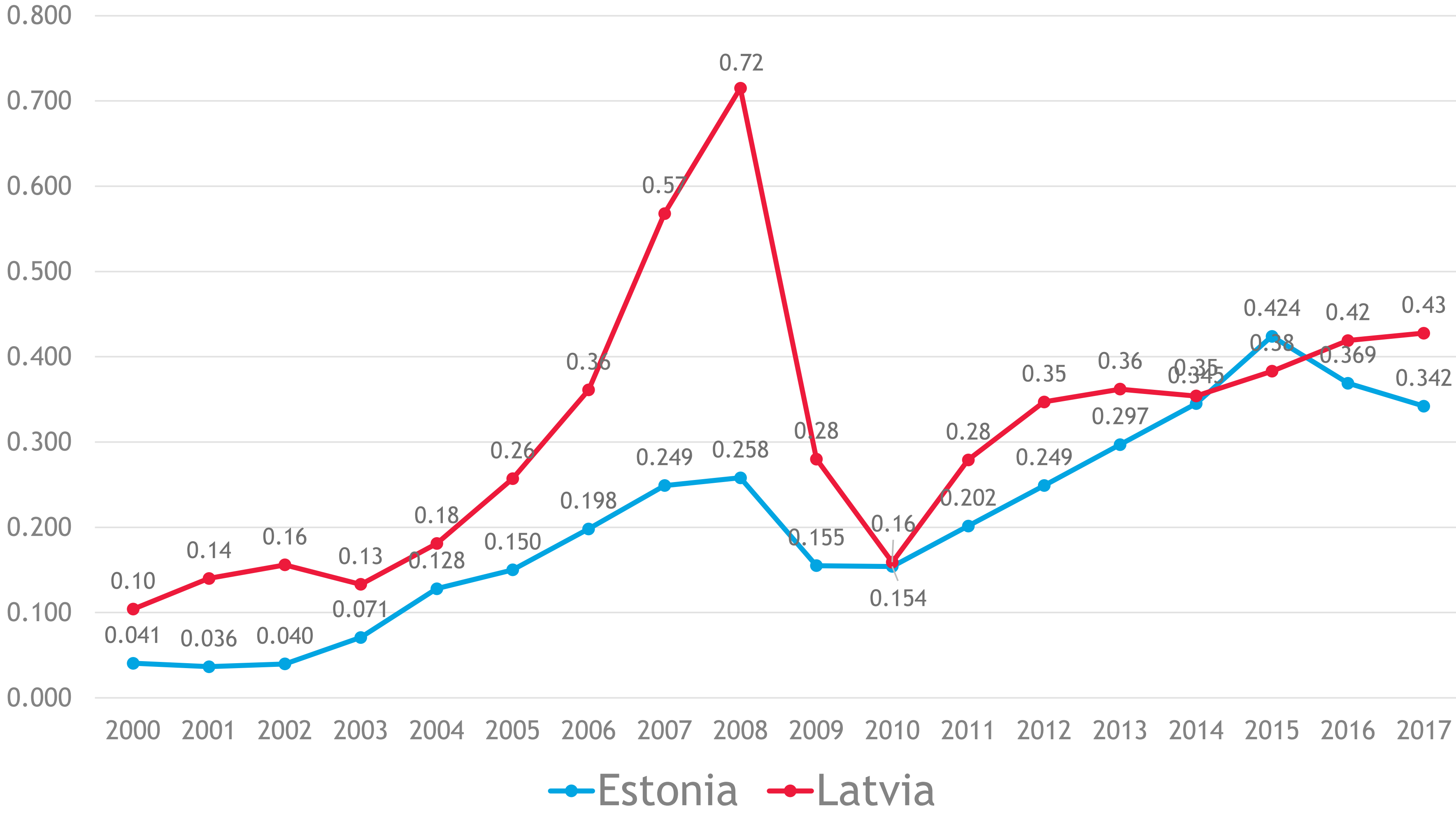
LATVIA - ESTONIA

	LATVIA	ESTONIA
Tax base	**Distributed profit:** ¤ calculated dividends (including exceptional dividends); ¤ profit distributions (for other legal forms) ¤ conditional dividends (increase of share capital by transfer of undistributed profit)	**Distributed profit:** ¤ calculated dividends (including exceptional dividends); ¤ profit distributions (for other legal forms) ¤ conditional dividends

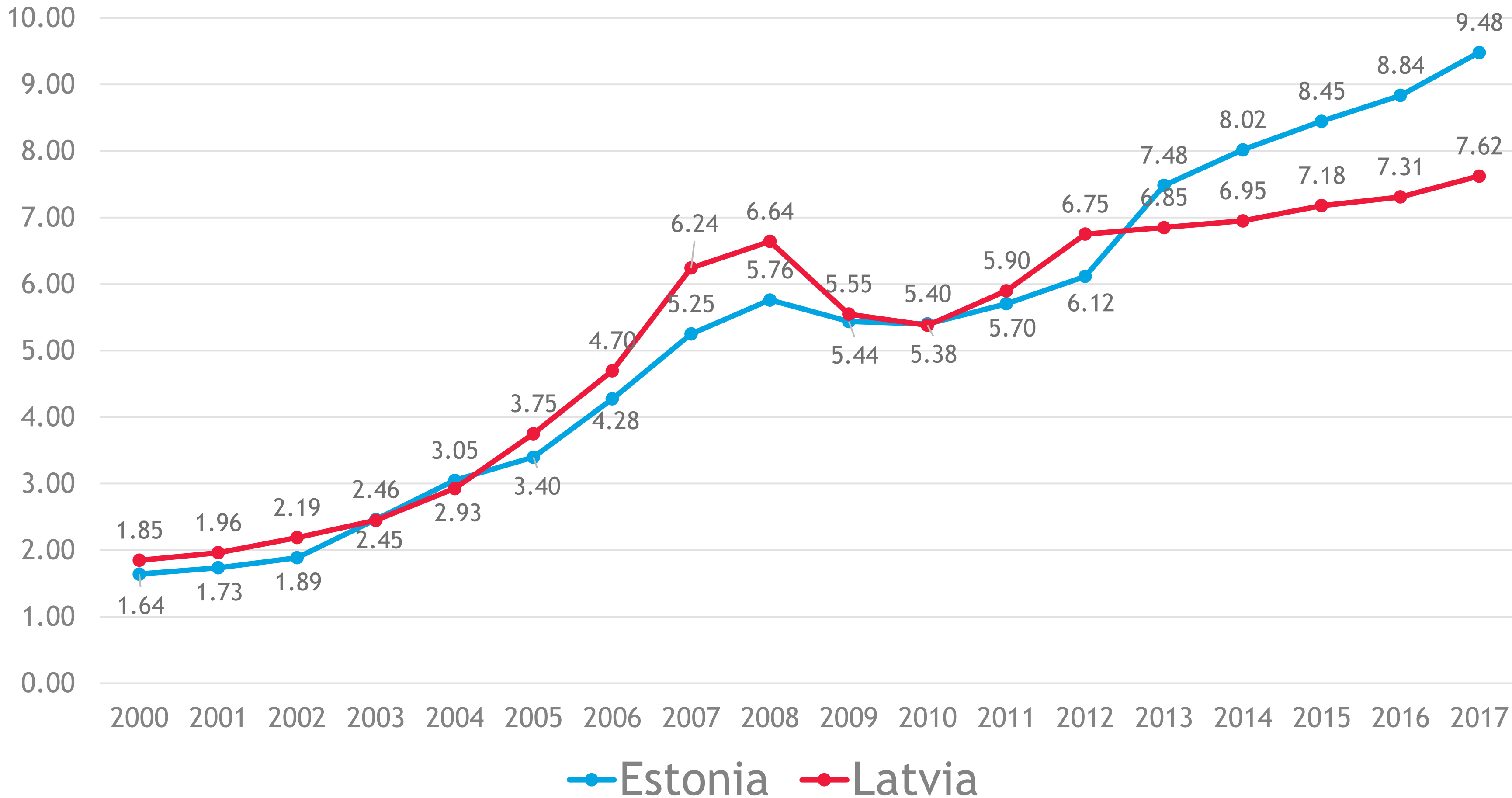
	LATVIA	ESTONIA
Tax base	**Deemed distributed profit:** • expenses not related to economic activity (including expenses for acquisition and maintenance of the representative vehicle, donations, costs related to the assets not used for business purpose, penalties, fines, other costs); • liquidation quota • Difference calculated due to transfer pricing adjustments • Written off doubtful debts if no activities provided to recover debts (artificial cancelation of debt) • Increased interest payments (Thin cap rules, proportion 1:4) • Loans to related parties (special regulation, short term loans exempted) • Any benefit in kind provided to employee attributable to PE in Latvia	**Deemed distributed profit (two types):** • The explicit way stands for dividends and other profit distributions (except for bonus issue, which is taxable for resident natural persons upon the alienation of assets received through the bonus issue). • Payments upon proceeds from liquidations, payments upon capital reductions and redemption or return of participation in a company are generally subject to corporate income tax in the hands of the payer: an Estonian company at the moment of distribution. • The implicit way to distribute profits is to do that through fringe benefits, gifts and donations, as well as expenses and payments unrelated to business activity (special treatment, non personalized, applies to shareholders).

CIT REVENUES IN ESTONIAN AND LATVIAN BUDGET

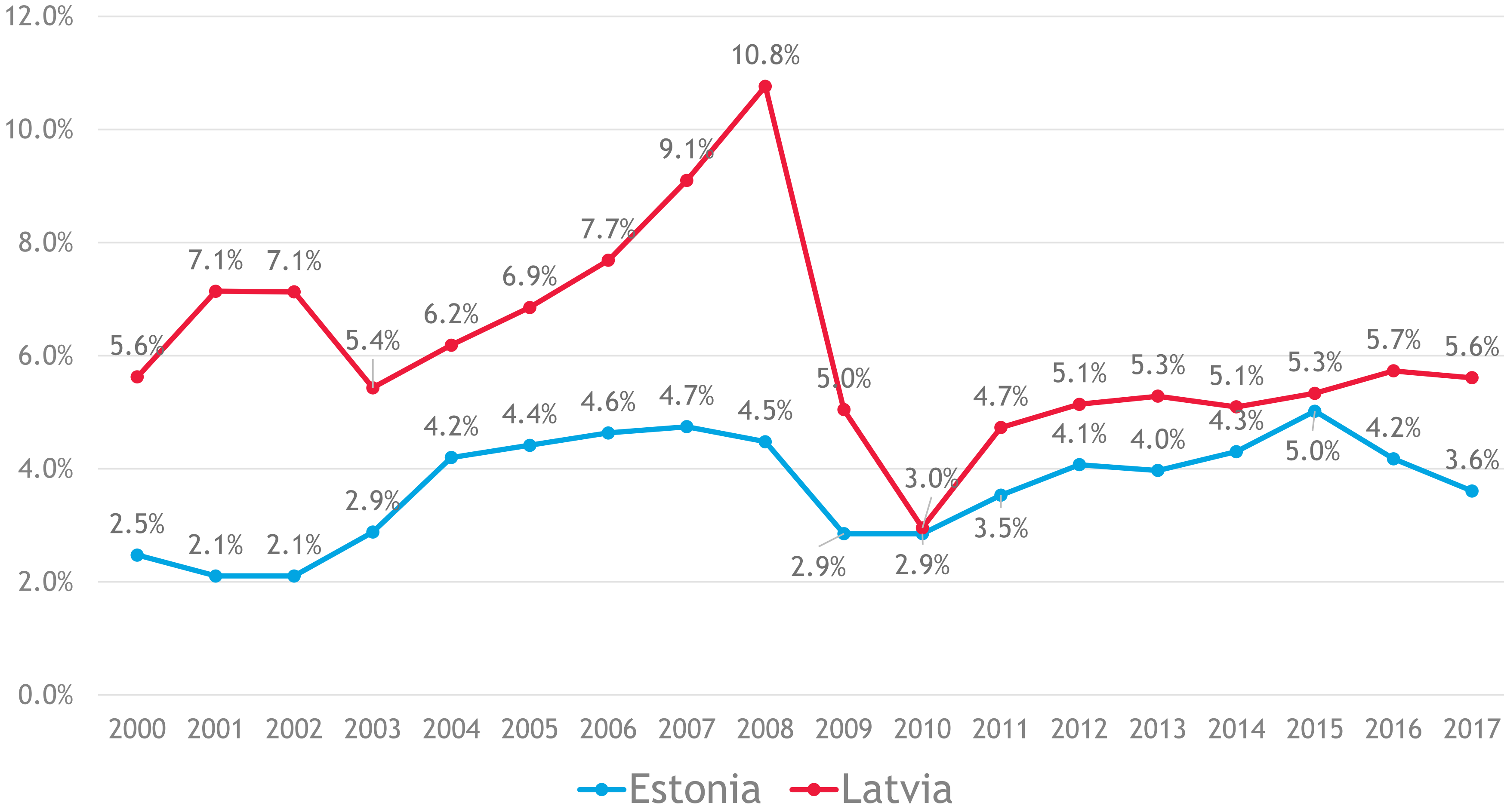
CIT REVENUES, IN BILLIONS EUR



STATE BUDGET REVENUES, IN BILLIONS EUR



THE ROLE OF CIT REVENUES IN STATE BUDGET, %



CORPORATE INCOME TAX 2018

CORPORATE INCOME TAX (CIT)

A new «Corporate Income Tax Law» is adopted, instead of the previous law «On Corporate Income Tax».

New tax payers:

- **Partnerships**
- **Cooperatives**

The taxable base consists of distributed profits and a conditionally distributed profits.

CIT RATE

The tax rate is **20%**

It should be noted that the taxable base should be divided by a factor of 0.8, i.e. (distributed profits + conditionally distributed profits)/0.8*20% or **25%**

If dividends are taxed with CIT and payed out to an individual, the income is not taxed with Personal Income Tax (PIT)

	2017	**2018**
Profits of the company	2000 €	2000 €
CIT	15%, i.e. 300	0% for retained earnings
Dividends calculated for the payout (individuals)	1000 €	1000 €
PIT	100 € (1000*10%)	0%
CIT		250 € (1000 / 0.8 * 20%)
Total taxes	**400 €**	**250 €**
Payout	**900 €**	**1000 €**

TAXABLE INCOME FOR NON-RESIDENTS

20%

Management and consultancy services

3%

Alienation of real estate in Latvia

20%

Payments to low tax countries

If the tax has not been withheld and paid to the budget at the time of payment, the paying agent must increase the tax base of the CIT for the amount paid to a non-resident. To calculate the tax payable, the base is divided by a factor of 0.8 and multiplied by the applicable tax rate.

$$20\% \rightarrow \frac{20}{80} \rightarrow 25\%$$

$$3\% \rightarrow \frac{3}{80} \rightarrow 3.75\%$$

DIVIDEND TAXATION (1)

Dividends tax rates		
	CIT system until 2018	CIT system after 2018
	Legal entities	
Payer of dividends	15% CIT from profit	25% CIT from distributed profit (paid in dividends or in a similar manner)
Recipient of dividends (resident)	0%	0%
	Natural person	
Recipient of dividends (resident)	10%	0%
	Latvian holding	
Recipient of dividends	0%	0%
	Low tax/zero tax country	
Payer of dividends	15%	45%

Effective rate on dividends		
	CIT system until 2018	CIT system after 2018
Legal entities (payer of dividends)	15 % CIT from profit	25% CIT from distributed profit
Natural person (recipient of dividends)	10% PIT from income	0%
Σ total	***25%***	***25%***

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DIVIDEND TAXATION(2)

- Payment of the tax for the distributed dividends has to be made only in the first stage when the decision about profit distribution is made in the first company.
- When the profit is distributed further to the parent company, no additional tax has to be withheld.

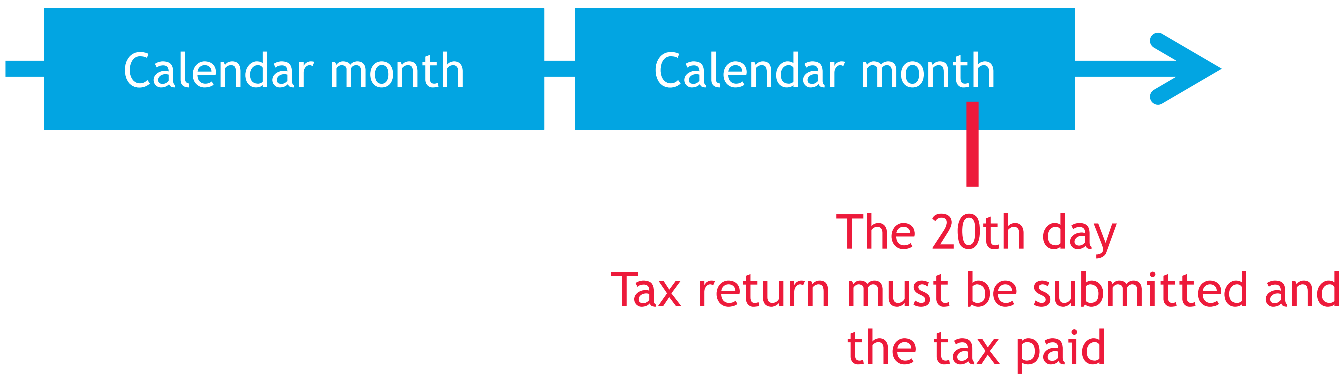
CIT tax law ensures that distributed profit is taxed only once

- Tax on the distributed profits is not a withholdoing tax within the meaning of EU Parent-Subsidiary Directive.
  - *Does not comply with withholding tax criteria set by ECJ:***

  1) *the chargeable event for the tax is the payment of dividends or of any other income from shares,*
  2) *the taxable amount is the income from those shares*
  3) *the taxable person is the holder of the shares.*

**ECJ Case law: C-446/04, C-231/05, C-284/06

TAXATION PERIOD



Declarations submitted quarterly by:

- individual merchants
- individual companies
- farmers and fishermen's farms

whose turnover (revenues) from economic transactions in the previous financial year does not exceed 300 000 €.

TAX ADVANCE PAYMENTS

January - June	July 1	July 20
1/12 of CIT for 2016 each month by the 20th day, excluding tax discounts for donations	Advance payments are cancelled	Return

These advances are taken into account when making the tax payment, calculated according to the declaration for the taxation period from January 1 to June 30, 2018.

DIVIDENDS

- Only the first distribution is taxed
- Received dividends are not taxed

Transition period

The taxpayer can exclude the profits which have been distributed as dividends and appear on the balance sheet on December 31st 2017 from the taxable base.

2018 – 2019 is the transition period for paying dividends **to an individual** (taxed at personal Income Tax rate 10%). Following which a 20% tax will be applied.

In the following years, the remaining retained earnings must be reduced by the amount of the calculated dividends.

TRANSACTIONS WITH RELATED PERSONS
LOANS TO RELATED PARTIES

Loans to related parties are taxable transactions:

- Loans to shareholder company, sister company
- Loans from company to its foreign permanent representation

TRANSACTIONS WITH RELATED PERSONS
LOANS TO RELATED PARTIES

Loans are not taxable if :

- loans in the amount of money received from an unrelated person;
- loans issued during the reporting year if, at the beginning of the previous year, the retained earnings of previous years do not occur in the balance sheet
- loans in the amount that does not exceed the amount of registered share capital registered at the beginning of the reporting year
- loans with duration up to 12 months

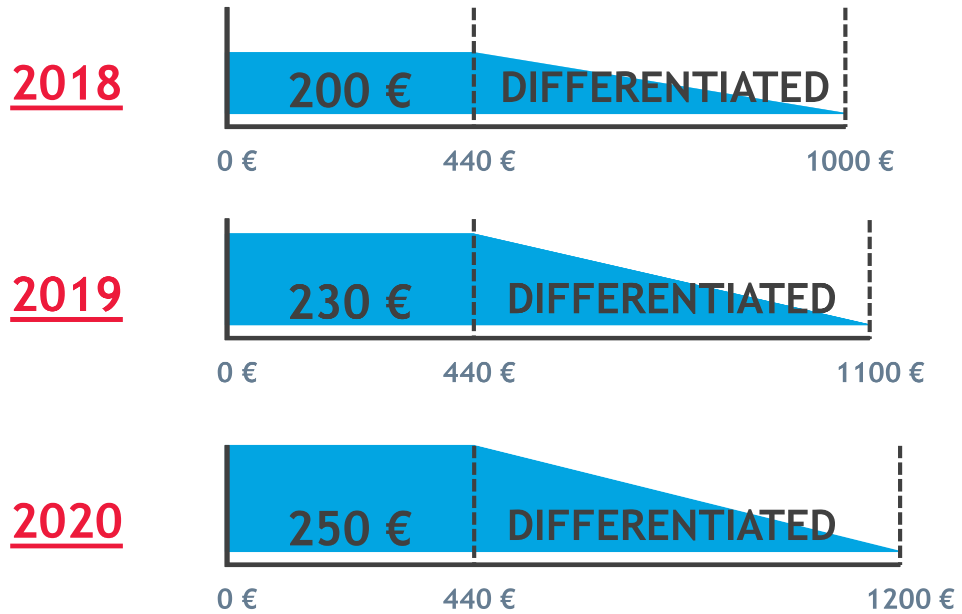
PERSONAL INCOME TAX 2018

PERSONAL INCOME TAX (PIT)

Minimum wage

2017		2018 - 2020
380 €	→	**430 €**

NON-TAXABLE MINIMUM



Monthly differentiated non-taxable minimum is projected by the SRS

Announces to the employer by January 1 and August 1 each year, using the EDS

PENSIONERS

2017	2018	2019	2020
235 €	250 €	270 €	300 €

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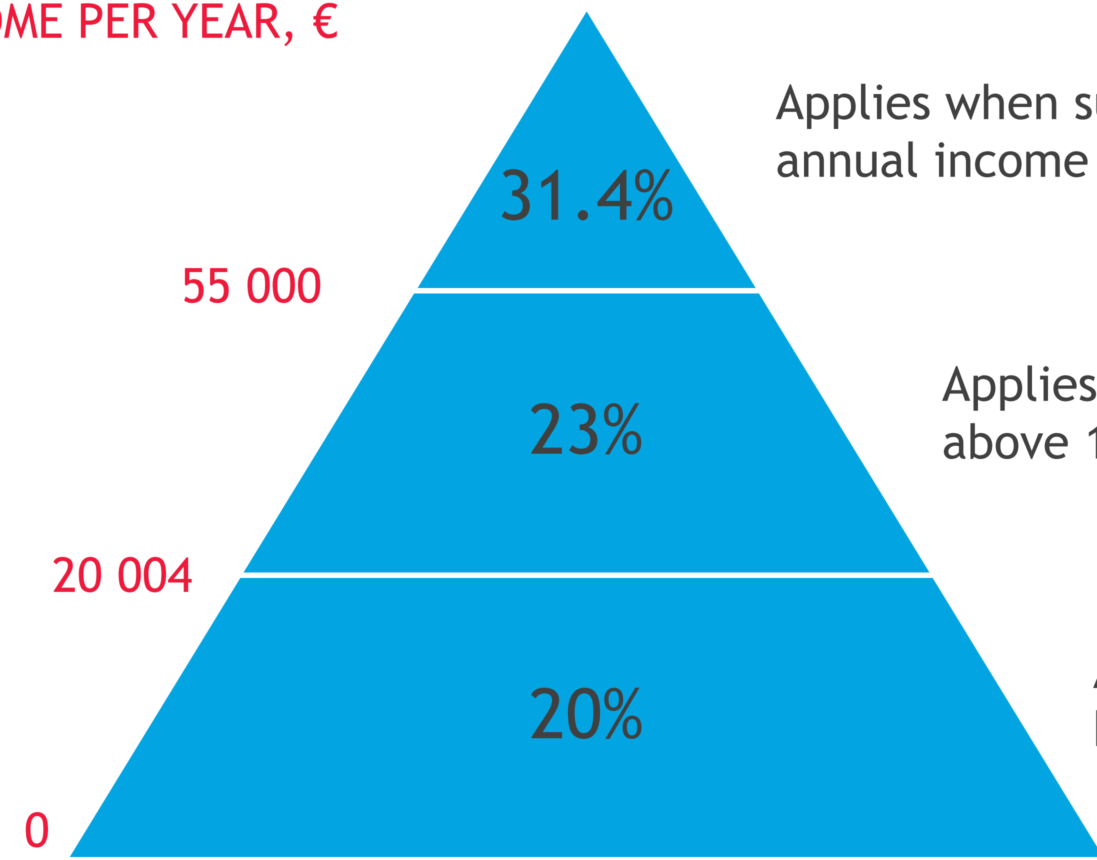
PROGRESSIVE PIT RATE

INCOME PER YEAR, €



Applies when submitting the annual income declaration

Applies to a monthly income above 1667 €

Applies to a monthly income below 1667 €

CAPITAL INCOME RATE

Dividends interest income

2017

10%

Alienation of shares and real estate

2017

15%

01.01.2018

20%

From capital income

Including income from investment of payments in private pension funds; income from life insurance contracts entered into with an accumulation of funds

2018 - 2019 is the transition period for paying dividends to an individual - 10%. Following which a 20% tax will be applied.

Withholding income from disposal of non-resident capital assets

2017

2%

2018

3%

SOCIAL CONTRIBUTIONS

TAX RATE

	2017		2018
Employer	23.59%	Employer	24.09%
Employee	10.50%	Employee	11.00%

This one percentage point increase will be channeled to a new type of social insurance - health insurance.

The solidarity tax is maintained and corresponds to the new social contribution rate.

AMENDMENTS IN TRANSFER PRICING REGULATORY ACTS

TRANSFER PRICING REQUIREMENTS

CIT law, Section 4, Part 2, Sub-part 2(e)

> *CIT base shall be impacted by:*
>
> > *Income, that a taxpayer would have received or expenses that a taxpayer would not have incurred if the commercial and financial relations would have been established between independent persons and if the transaction value would have been at arm's length. Methods for calculating the arm's length value are determined by the Cabinet of Ministers Regulations.*

The new redaction of Section 15.[2] of the law should implement Local file and Master file requirements for related-party transactions with non-residents (OECD BEPS Action 13).

BEPS Action 13 call for the adoption of a standardised three-tiered approach to transfer pricing documentation consisting of:

- Country-by-Country Report (CbCr)
- Master file (MF)
- Local file (LF)

AMENDMENTS TO THE LAW «ON TAXES AND DUTIES»

Law «On taxes and duties», Section 15.2 (draft)

Provisional threshholds (tbc):

<table>
<tr><th></th><th>MF</th><th>LF</th><th colspan="2">Deadlines for submission</th><th>Fines</th></tr>
<tr><td rowspan="3">Related-party transactions with <u>non-residents</u></td><td>Transaction value > EUR 15 000 000 <u>OR</u> revenue > EUR 50 000 000 and transaction value > EUR 1 000 000</td><td>Transaction value > EUR 5 000 000</td><td colspan="2">Within 7 months after the end of the financial year.</td><td rowspan="4">Up to 1.5% from transaction value if not submitted on time;

Up to 1% from transaction value if substantial TP requirement violations</td></tr>
<tr><td>Transaction value from EUR 1 000 000 to 15 000 000 and turnover < EUR 50 000 000</td><td></td><td>With the annual return or MNE group's consolidated return (whichever is later).</td><td rowspan="2">To be submitted within 1 month upon request by tax authorities.

To be reviewed annually.

Motivated request for extension possible.</td></tr>
<tr><td></td><td>Transaction value from EUR 250 000 to 1 000 000</td><td>With the annual return or within 4 months after the end of the financial year (whichever is later).</td></tr>
<tr><td>Related-party transactions with <u>residents</u></td><td>N/A</td><td>Transaction value > EUR 250 000 and requested by the tax authorities</td><td>Within 60 days upon request by tax authorities.</td><td>Tax authorities may request full or partial TP documentation</td></tr>
</table>

AMENDMENTS TO THE LAW «ON TAXES AND DUTIES»

Law «On taxes and duties», Section 5, Part 5, Sub-parts 5. and 6.

Master file

MNE's:

- Legal and organisational structure
- Description of the entity's business activity
- Non-tangible assets
- Information on financial transactions
- Financial information

Local file

- Information about the taxpayer (legal and organisational structure, the company's strategy, main competitors, etc.)
- Information on each material controlled transaction or its' category (description of transaction or category, transaction value, agreement copies, functional analysis, substantiated choice of a TP method, etc.)
- Financial information (Annual return, information on comparable data, etc.)

TP documentation must be available in electronic format with search function available.

Categories - product manufacturing, purchase of goods, provision of services, loan agreement, issue of licence for intangible assets, etc.

If due to threshold requirements the taxpayer must only prepare LF, it must contain informaiton relevant to the whole MNE group (i.e. the group's organisational and legal structure, performed functions, undertaken risks and used assets.

LATVIAN TAX REFORM – TAX PLANNING POTENTIAL

LATVIA - NEW HOLDING CHAMPION OF EU (LIKELY NOT)

LATVIA – SAVINGS BOX OF GLOBAL MNCs (POTENTIALLY)

How to make ultimate profit distributions outside Latvia? (THE KEY QUESTION)

THANK YOU!

For any questions, please contact:

Janis Zelmenis
BDO Latvia
Managing Partner
T: +371 6677 7800
E: janis.zelmenis@bdo.lv