



Search

NEWS FROM ESTONIA, LATVIA AND LITHUANIA

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**THIS WEEK**

News  
Estonia <  
Latvia <  
Lithuania <  
Business  
Finance  
Sports  
Opinion  
Outlook

**ENTERTAINMENT**

Out & About  
Cinema

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Classifieds  
Real Estate  
Business Calendar  
Jobs  
Advertise

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About us  
Contact  
Letter to the Editor  
Forum

**SPECIALS**

Specials  
Advanced search

**TBT EVENTS**

TBT Open

**ARTICLE**

22.02.2006

**Talking tax***By Janis Taukacs, Luc Nijs [ Sorainen Law Offices ]***VAT on transfer of business: the "no supply rule"**

Recently one of our clients expressed a wish to purchase a certain business in Latvia and requested our evaluation of the associated tax risks for such a transaction. One of our findings related to the VAT application on the purchase is that under Latvian law this would be subject to VAT (18 percent) unless the transfer is part of a formal reorganization process.

This created for our client a serious headache because the input VAT surplus created cash-flow difficulties as the amounts were significant: the Latvian state in this way acquires an interest-free loan for a considerable amount of time (in some occasions even longer than a year). The amounts "frozen" in such transactions usually are not "immaterial."

The 6th Council Directive (77/388/EEC) allows member states to consider that no supply of goods has taken place in cases of a transfer of business as a going concern and in the event that the recipient must be regarded as the successor to the transferor. Thus, member states may choose whether to apply this "no supply rule," making all the transfers either subject to VAT or not.

However, Latvian VAT law introduces a strange "stuck-in-the-middle concept" – they applied the "no supply rule" to the transfer of business resulting from a formal reorganization process only, thus excluding purchases of a business (unit). It would be correct, though, that Latvia chooses to apply this "no supply rule" to all transfers of business since it has chosen to apply the rule at all. In our opinion, the option in the directive whether to apply the rule does not leave room for a partial implementation.

In reply to our letter to the Latvian Ministry of Finance, where we suggested to amend the law, the ministry indicated that a transfer of a business as a going concern can only occur in the form of a formal reorganization. Such conclusions, of course, are unfair from the commercial law point of view.

The good news is that unofficially we have received indications that together with the coming amendments to the government regulations (expected to be adopted soon) the corresponding articles will be amended in order to also apply the "no supply rule" to the transfers of a business unit. However, in order to be on the safe side, the Law "On VAT" itself should be amended as well.

Our clients in Lithuania are facing similar difficulties as in Latvia, whereas the businesses are lucky in Estonia, as the Estonian law applies the "no supply rule" to transfers of business in accordance with the above understanding of the 6th Directive.

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