



LATVIA

THIN CAPITALISATION REGULATIONS AND SIMILAR TAX LIMITATIONS ON LEVERAGE BUY-OUTS, OR HOW TO SET THE LIMIT TO YOUR TRANSACTION

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1. Questionnaire

1.1. Deductibility of interest expenses at the level of the borrower

1.1.1. Interest definition

3.1.1.1 How is 'interest' defined in your jurisdiction?

Interest is defined as income from any debt obligations, income from government emitted securities, and income from bonds or promissory notes, including premiums and bonuses pertaining to such securities, bonds or promissory notes.

3.1.1.2 Is a statutory definition available or has your definition been developed as a result of case law and/or administrative practice?

This is a statutory definition given in the Latvian Law On Corporate Income tax

3.1.1.3 Can the qualification of a payment as 'interest' be converted into a qualification as a "dividend" under a specific statute or under general anti-avoidance rules (or doctrines), or both?

Latvian Statute or general law has no provision to convert an interest payment into a dividend payment

3.1.1.4 Is the distinction between interest and dividends based on the legal form or on the economic substance of the underlying asset?

The distinction is provide by their definitions. "Dividends" are statutorily defined as income in cash or in kind from capital shares or stocks of a

commercial company or co-operative societies co-operative shares, or other rights, not resulting from debt obligations, to participate in the distribution of profits of such a commercial company or co-operative society.

The term "dividend" does not apply to income in cash or in kind received in the event of the liquidation of a commercial company or co-operative society, as well as the distribution of the profits of a partnership.

3.1.1.5 Is it possible that interest on a profit participating or alike loan qualifies in your jurisdiction as a dividend? Under which circumstances?

The above definition excludes the right to participate in a distribution of profits arising from a debt obligation as creating a dividend payment

3.1.1.6 What are the characteristics, facts and/or circumstances which are taken into account in your jurisdiction to qualify income as interest rather than as dividend?

Application of the statutory definition will determine whether an income amount is categorised as an interest or dividend payment.

1.1.2. Deductibility of interest expenses

3.1.2.1 Is, as a general rule, interest a tax deductible expense in your country?

Yes.

3.1.2.2 What are the general conditions for the deduction of interest?

Interest that can be shown to be an expense that is directly related to the economic activity of an entity will be deductible.

The term economic activity is defined to be - activity directed towards the manufacture of goods, the performance of work, a trade, the provision of services or other form of activity for remuneration.

3.1.2.3 Does your jurisdiction has limitations on the deductibility of interest expenses other than thin-capitalisation or alike rules (e.g. limitations for interest payments to low tax, off-shore or other "tainted" jurisdictions)?

If interest is paid to a related party the interest rate imposed must be an arms length rate in accordance with Latvia's transfer pricing rules. Accordingly, interest paid in a related party loan can be adjusted to have an amount in excess of market rates deemed non deductible.

Interest paid to nil or low tax jurisdictions does not limit its deductibility. However, it will be "deemed" a related party transaction and the interest rate charged must be at arms length.

The payment will also be subject to a 15% withholding tax if it is not interest paid by a Latvian registered credit institution on deposits and balances of current accounts and the interest is paid according to the general rate determined by the credit institution for deposits and balances of current accounts;

3.1.2.4 Are any limitations only applicable to interest payments or do they also apply to other financing costs (losses on debt, etc.)?

Latvia's thin capitalisation rules only apply to interest payments. There are no other limitations regarding financing costs except for the application of the general principle that the costs must be directly related to the business operations of an entity.

You have mentioned "losses on debt" in your question. If this refers to losses that for accounting purposes would be categorised as "bad debts" certain conditions would have to be complied with before a bad debt is allowed to be deducted for taxation purposes.

3.1.2.5 Is interest only deductible provided the borrowed funds are used to earn ordinarily taxed income, i.e. income that is subject to the ordinary corporate income tax regime and hence is not tax free or exempt (e.g. tax free or exempted gains or dividends on shares)?

As mentioned earlier, interest that can be shown to be an expense that is directly related to the economic activity of an entity will be deductible.

In calculating a Latvian corporate taxpayers assessable income the starting point is the annual financial profit and loss result which is then subject to taxation adjustments. There are no specific provisions that disallow interest if it results in the receipt of tax free or exempt income. Accordingly, if the interest is an expense that is directly related to the economic activity of an entity and this activity results in tax free or exempt remuneration it should be capable of deduction.

Latvia has no specific anti-debt push down provisions; however it could be argued that an interest expense pushed down into a target entity is not directly related to the economic activity of that entity.

3.1.2.6 Is there any subject to tax requirement? Is interest e.g. only deductible provided the interest is effectively taxed in the hands of the creditor? Does your jurisdiction require that the interest also qualifies as interest in the state of the creditor?

There is no requirement the interest paid is subject to tax or qualifies as interest in the state of the creditor

3.1.2.7 Does your jurisdiction require that the borrowed funds are used to finance domestic business activities?

No. There is no requirement that funds are used to finance domestic business activities. The only requirement for tax deductibility is that the funds be directly used for the entities economic activities.

3.1.2.8 Is your jurisdiction in this respect making any difference between domestic and cross-border interest? If so, and provided your are reporting for a EU country, how is practice dealing with this in light of the ECJ rulings in the Bosal and Cadbury Schweppes cases?

There is no distinction in Latvia between domestic and cross border interest expenses. However, the expense must be directly related to the economic activities of the entity.

3.1.2.9 Does your jurisdiction or administrative practice allow the deduction of so-called 'deemed interest deduction' (e.g. deduction of deemed interests on interest free loans?)

No deemed interest deductions are allowable in respect of interest free loan. As of 2010 a deemed interest deduction will be allowed on retained earnings that are classified as a substitute for actual borrowings.

3.1.2.10 Are there any compliance or other formal requirements to deduct interest expenses? Is transfer pricing documentation required? If so, in which case? To what extent (e.g. benchmarking study required, comparable offer of third party, ...)?

There must be sufficient documentary evidence to support the receipt of the principal amount and the payment of the interest. If the loan is from a related party or is a transaction that is deemed to be with a related party (such as with an entity located in a nil or low jurisdiction) these transactions must be reported as part of the annual income tax declaration procedure. In reporting a related party loan transaction the taxpayer must also state the transfer pricing method used to arrive at the arms length rate of interest applied to the loan. In this regard, there should also be transfer pricing documentation available that explains the basis for adopting a particular method.

1.1.3. Thin capitalisation rules

3.1.3.1 Does your jurisdiction impose thin capitalisation rules or rules having a similar effect?

Latvia has thin capitalisation rules. However, the rules do not apply to credit institutions and insurance companies, as well as to interest payments for credits, leasing services and loans, which are received by credit institutions registered in the Republic of Latvia or in another Member State of the

European Union, the Latvian Treasury, the Nordic Investment Bank or from World Bank group, as well as from residents of the Republic of Latvia.

3.1.3.2 Does your country apply debt/equity ratio or other ratio's based on e.g. EBIT or EBITDA? Please summarise your thin cap or similar rules?

The Latvian thin capitalisation rules are as follows.

The maximum amount of annual deductible interest is determined by making two separate calculations. If an amount of non deductible interest results from either or both the calculations, taxable income is increased by the largest amount calculated.

(i) First calculation

Under the first calculation, the amount of interest allowable is determined by multiplying the principal amount outstanding during the year by 1.2 times the average short-term interest rate for the last month of the taxation period as determined by the Latvian Statistics Commission. This is then compared to the actual interest paid.

(ii) Second calculation

Taxable income is to be increased for interest paid by an amount that is proportional to the amount by which the average amount of the principal payable during the year exceeds a multiple of 4 times the company's equity as stated in its annual accounts at the beginning of the year, which is then reduced by any amounts that are long term investment revaluation reserves or other reserves that are not reflected in the profit and loss statement.

If a taxpayer's accounts do not reflect equity amounts only the first method is used.

3.1.3.3 Are these ratios calculated on a stand alone or consolidated basis?

The law does not require that each loans interest deductibility to be calculated on a stand alone basis. Accordingly, we consider the ratios can be calculated on a consolidated basis.

3.1.3.4 Are the rules only applicable in case of cross border interest payments or also in domestic situations?

The rules are applicable in all situations save for circumstances where the loans are provided by the lenders noted at 3.1.3. 1. above.

3.1.3.5 Do the rules only apply in case of intra-group financing or do they also apply to third party loans?.

Please see 3.1.3.4.

3.1.3.6 Are the rules only applicable to interest payments or do they also apply to other financing costs (losses on debt, etc.)?

The rules apply to interest as defined in the law and also interest received in discount form as well as any other payments, which on the basis of the economic essence of the transaction is an interest payment irrespective of the legal form of the transaction.

Separate rules apply to the deductibility of bad debts.

3.1.3.7 If a debt / equity ratio applies, please briefly explain how the amount of debt and the amount of equity are calculated?

Please see 3.1.3.2.

3.1.3.8 Is it an option to contribute shares of a group company or other assets into the share capital of the borrower in order to boost the borrower's equity? Are there any other optimisation techniques or anti-avoidance rules that may apply?

Latvia imposes no restrictions as to how a borrowers equity is established save for it being in accordance with the Latvian Commercial law and applicable accounting principles. Normally an increase is made in the companies share capital by way of a debt for equity swap or cash or in kind payment.

3.1.3.9 Is there an interaction or other relationship between your thin cap rules and your transfer pricing rules? Is it e.g. possible to deviate from the D/E-ratio (or other ratio's if any) in case the taxpayer can demonstrate that another ratio still meets the arm's length standard?

There is no interaction with Latvia's transfer pricing regulations. The thin capitalisation rules operate on a stand alone basis.

3.1.3.10 What is the effect of the application of thin cap rules in your country? Is the interest qualified into a non-deductible dividend triggering dividend withholding tax instead of interest withholding tax? Does the sanction apply to the whole interest expense, or does it only apply to the interest paid in excess of the limitation imposed? Or, is the interest simply non-deductible? Any other penalties?

The larger amount of excess interest that is calculated under the two methods is non deductible. There are no other penalties.

3.1.3.11 Does your jurisdiction allow a carry forward of non-deductible interest?

No carry forward of non-deductible "tainted" interest is allowed.

3.1.3.12 Are you aware of any case before the European Court of Justice involving your country where your domestic thin cap or similar rules are questioned?

We are not aware of any case.

3.1.3.13 Provided you are reporting for an EU country, are your thin cap or similar rules in line with the ECJ case law?

We cannot provide a response to this as we are unsure of all the relevant ECJ case law.

3.1.3.14 Timing of the deduction: is interest in your jurisdiction deductible on an accrual basis or only as from actual payment?

Corporate entities deductions for interest are allowed on an accruals basis.

3.1.3.15 Please summarise your general rules?

The accounting rules applicable in Latvia determine the recognition of interest as an annual expense. These rules are based on European accounting principles.

1.2. Withholding tax (WHT) on interest income

1.2.1. General

3.2.1.1 Is, as a general rule, interest subject to interest withholding tax?

Interest withholding tax is only payable if both parties are "related". The general rate is 10% with a 5% rate applicable to interest paid between a Latvian registered commercial bank and a foreign related entity.

From 1 July 2009 the 10% rate will reduce to 5% if the interest is paid to a related entity (including a permanent establishment) that is registered in the European Union. From 1 July 2013 there will be no withholding tax imposed on interest paid to a related entity that is registered in the European Union.

The above exemptions can also apply to interest payments received or made by a European Union resident's permanent establishment if certain conditions are met.

Interest paid to nil or low tax jurisdictions is "deemed" a related party transaction and the payment will be subject to a 15% withholding tax if it is not interest paid by a credit institution registered in the Republic of Latvia on deposits and balances of current accounts, and the interest is paid according

to the general rate determined by the credit institution for deposits and balances of current accounts.

The withholding tax on a nil or low tax jurisdiction loan can be reduced to the standard rate if approval is given by the Latvian taxation authorities on the basis the payment is not being made to avoid Latvian taxes.

3.2.1.2 Are domestic and cross-border interest payments subject to different rules in this respect?

Withholding tax does not apply to domestic interest payments.

3.2.1.3 Is there any interaction between your interest WHT and your thin cap rules or similar limitations? May non-deductible interest payments be subject to WHT?

There is no specific interaction. Non deductible "tainted" interest can be subject to WHT.

3.2.1.4 Provided you are reporting for an EU country, are your rules in line with the ECJ case law?

On the basis of the ECJ decision in the "Truck Center" case (C-282/07) it could be considered that by only imposing withholding tax on non Latvian resident related companies Latvian rules are not in line with ECJ case law.

1.2.2. Exemptions from WHT (internal law)

3.2.2.1 Please explain the most important exemptions from interest WHT contained in domestic law?

If interest is not paid to a related entity no WHT tax is applicable. Please also see the transitional provisions listed in 3.2.1.1.

3.2.2.2 Is, under your domestic rules, a WHT exemption available for payments to domestic or foreign credit institutions (e.g. banks)? If yes, under what conditions? Please do not elaborate further with respect to interest payments between banks.

Withholding tax does not apply to domestic payments. There is no current exemption for interest paid to a foreign bank. A 5% rate is applicable to interest paid between a Latvian registered commercial bank and a foreign related entity which could include a bank.

From 1 July 2013 there will be no withholding tax imposed on interest paid to a related entity that is registered in the European Union and which could include a bank.

3.2.2.3 Are there any general conditions to comply with in order to have a reduced WHT or WHT exemption? Is exemption from WHT e.g. subject to effective taxation of the interest in the hands of the creditor? Are there any conditions relating to the identity of the lender?

Please see 3.2.1.1. The imposition of withholding tax is not subject to the effective taxation of the interest in the hands of the creditor. In regard to the identity of the lender the conditions that are applicable are, is the entity a related entity or is the entity located in a nil or low tax jurisdiction.

1.2.3. Exemptions from WHT (Double Tax Conventions or EU law)

3.2.3.1 If you are reporting for a EU member state, did your country stick to the text of the EU Interest & Royalty Directive when transposing this directive in internal law or has been opted for less strict conditions (e.g. shorter holding period requirement, lower participation requirement, ...)? Does your country e.g. also allow an 'indirect' shareholding of 25% in order to qualify as an "associated company" (see article 3 (b) of the Directive)? Any other important differences between the text of the Directive and your domestic provisions?

The taxable income of a Latvian entity is decreased by the amount of dividends received from a non-resident, if the dividends received simultaneously meet the following conditions:

1. the dividends are received from a non-resident in whom at the time of the payment, the Latvian entity owns at least 25 per cent of the capital and voting rights; and

2) the payer of the dividends is a resident of a state or territory, which, in accordance with Latvian Ministers Cabinet regulations, is not listed as a low-tax or no-tax state, or territory.

The taxable income of a Latvian entity is also not increased by a dividend payment, which is to be received from a company referred to in Section 1, Paragraph nineteen of the Corporate Income Law being a resident of another Member State of the European Union or resident of a state of the European Economic Zone.

A foreign entities Latvian permanent establishment's income is also not increased by a dividend payment, if the permanent establishment is a permanent establishment of a company referred to in Section 1, Paragraph nineteen of the Corporate Income Law being a resident of another Member State of the European Union or resident of a state of the European Economic Zone and the dividend which is to be received is from a company referred to in Section 1, Paragraph nineteen of the Corporate Income Law being a resident of another Member State of the European Union or resident of a state of the European Economic Zone.

3.2.3.2 Please list the Double Tax Conventions concluded by your jurisdiction under which a full exemption of WHT is available?

Only the Double Tax Convention with Lithuania provides for a full exemption of interest withholding tax.

3.2.3.3 If you are reporting for an EU member state, are there any Double Tax Conventions concluded by your country providing exemptions beyond the exemptions provided in the EU Interest & Royalty Directive? If so, what are the conditions?

The Double Tax Convention with Lithuania provides for a full exemption of withholding tax for both interest and dividend payments to a Lithuanian tax resident corporation.

In regard to dividends, the following conditions must be complied with;

- (a) the recipient is a company (other than a partnership);
- (b) the recipient is the beneficial owner of the dividends, and
- (c) holds directly shares representing at least 25 per cent of the capital and the voting power of the company paying the dividends.

In regard to interest, the recipient must be the beneficial owner of the interest to gain the exemption.

3.2.3.4 How is the term 'beneficial ownership' usually understood in your jurisdiction? Legal approach (based on legal rights of obligations between parties)? Economical approach (based on the economics of a transaction)? International meaning approach (OECD approach)? Other? A mix?

The Latvian taxation authorities have not issued any public guidelines as to the meaning of the term "beneficial ownership". Normal practice is to apply the OECD commentaries to the OECD Model Tax Convention.

3.2.3.5 Is the beneficial ownership condition or treaty shopping for that matter, in practice, a bottleneck in your jurisdiction? If so, how is practice dealing with this?

We are not aware of beneficial ownership being an issue with our taxation authorities.

3.2.3.6 Can you provide the General Reporters with an indication of the spread which is usually accepted by your tax administration in case of back-to-back arrangements? Is it possible to obtain an advanced ruling from the tax authorities on this spread?

No public instructions have been issued by the Latvian taxation authorities regarding back to back arrangements and an acceptable spread.

Binding taxation rulings can be applied for, however, in our opinion if a ruling was sought regarding a back to back arrangement there would be a significant risk the taxation authorities would look through the arrangement and hold that its underlying structure was a transaction between related parties and therefore subject it to withholding tax

1.3. Taxation of interest income at the level of the creditor

1.3.1. How is interest income taxed at the level of the creditor? It is

taxed as a normal revenue receipt.

1.3.2. When is the interest income included in the creditor's taxable basis?

For corporation it will be recognized on accruals basis. For an individual the normal practice is to recognize interest income on a cash basis.

1.3.3. Is any Foreign Tax Credit available for tax paid in relation to foreign-source interest? If so, please briefly explain the mechanics of such foreign tax credit?

Under domestic law, a tax credit is available for foreign taxes paid but is limited to the amount of tax payable in Latvia on the same income. Any excess credit is lost.

1.3.4. Is it possible in your country to claim participation exemption for interest income which is qualified as dividend income? If so, any general or specific anti-avoidance rules that may apply?

Latvian has no rules which qualify interest income as dividend income.

1.3.5. Does your country have anti-double dip rules?

Latvia has no anti-double dip rules

1.4. Recent developments

1.4.1. What are the most important changes in this field in your country during the last 5 years?

The most significant changes have been the changes required as a consequence of becoming an EU member state and the introduction of a transitional interest withholding tax rate reduction and eventual exemption for payments made to EU member state entities.

1.4.2. Are your rules expected to be changed significantly in the near future?

It is not expected that there will be any significant changes in the near future

1.5. Typical tax planning structures

1.5.1. Can you provide the General Reporters with an example of typical double dip structures involving your jurisdiction?

We are not aware of double structures in our jurisdiction. In regard to circumventing a related party relationship, back to back loans have been a planning structure.

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