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LITHUANIA

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. OUTLINE

Most countries have thin capitalisation rules limiting the tax deductibility of interest expenses. The rules usually refer to an allowed debt/equity ratio. Certain countries even implemented additional tests and also refer to the EBITDA of the debtor, either on a stand alone or on a consolidated basis. These rules have a substantial impact on the tax structuring in case of leverage buy-outs. The workshop highlights the variety of the existing rules and tendencies in the international tax practice.

2. INTRODUCTION

Interests paid out by a Lithuanian resident entity to a non-resident entity are subject to 10% withholding tax. Interest received by a resident entity from local or foreign entities increases the taxable base of a resident entity.

Lithuania has been granted with a 6-year transitional period for the implementation of the Interest and Royalties Directive. Therefore, interest and royalties paid to the associated enterprises covered by the Interest and Royalties Directive will be exempted from withholding tax as of 1 July 2011. During the period of last two years of the six-year transitional period (i.e. as of 1 July 2009) interest paid to such enterprises will be taxed at a 5% rate

3. ANALYSIS

- Deductibility of interest expenses at the level of the borrower
- Withholding tax on interest income
- Taxation of interest income at the level of the creditor
- Recent developments
- Typical tax planning structures

3.1. Deductibility of interest expenses at the level of the borrower 3.1.1.

Interest definition

3.1.1.1 How is 'interest' defined in your jurisdiction?

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According to the Law on Corporate Income Tax (Law on CIT), interest is defined as a remuneration for lending of money. The main characteristic of interest is that it is a fee paid by debtor and depends on the amount of borrowed amount and the length of borrowing. Any remuneration paid for the borrowing of the money is treated as "interest" regardless of how such remuneration is defined in the agreement.

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?

Yes, interest definition is established in the Law on CIT, additional comments regarding the scope of this definition are provided in the commentary on the Law on CIT, which is published by the State Tax Inspectorate.

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?

There is no specific statutory provision, which would be specifically designed for conversion of interest into dividend. However, in Lithuania a general anti-avoidance principle of substance over the form applies, on the basis of which the interest may be qualified as dividend.

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?

In our opinion the distinction is based on the economic substance of the underlying asset (see above 3.1.1.). Besides, taking into account that a general anti-avoidance principle (substance over the form) applies, the economic substance becomes even more significant.

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?

As noted, there is no specific statutory provision, which would be specifically designed for conversion of interest into dividend; however, we consider that in case the interest is based on profit, tax authorities may re-qualify the interest into dividends on the basis of general anti-avoidance principle of substance over the form.

Noteworthy that Lithuanian Law on CIT uses a definition of "income from distributable profit", which is defined as any income, received by shareholders from distribution of company's profits, including dividends.

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?

Economic substance should be analysed in order to define whether the amounts paid qualifies as interest or dividends.

3.1.2. Deductibility of interest expenses

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

In general, interest is a tax deductible in Lithuania.

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

Interest expenses paid by the company are tax deductible in case a loan is related to the economic benefit of the company or it allows earning income, which is necessary for the company.

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)?

Under the general principle, Law on CIT establishes certain restrictions applicable to the transactions with offshore entities. Under general provision, entities (including permanent establishments of foreign entities in Lithuania), cannot recognise the payments (including interest) made to offshore territory entity as tax deductibles for CIT purposes, unless it proves that (i) payments relate to ordinary and normal activities of parties to the transaction, and (ii) an offshore territory entity possesses assets necessary to conduct the activities, and (iii) there is a connection between the payment and the economically grounded transaction. The requirements applied to the documents to be submitted to the Lithuanian tax authorities are rather strict and makes the deduction of payments to the offshore entities very difficult to implement. Holding of offshore entity leads to application of controlled foreign entity (CFC) legislation.

Further, Lithuanian transfer pricing rules should be taken into account. If interest is paid to a related party, the interest rate imposed must be at arms length rate. Under general principle, if the value of transaction (e.g. interest rate) between related persons differs from the value of similar transaction between unrelated parties, then the tax authority may adjust the value of the transaction for tax purposes.

In addition it might be noted that certain restrictions are established for deductibility of the interest in case of merger of the companies, in particular, deductibility restrictions applies for interest paid by acquiring company for the loan taken in relation to acquisition of a target company in case such acquiring company merges with a target company following such acquisition.

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.)?

Some of mentioned limitations are applied to interest payment only (e.g. interest paid for the loan taken for acquisition of the shares), other are applied to various kinds of costs (e.g. transfer pricing rules, payments to offshore territory).

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 it is mentioned in section 3.1.2.2. above, interest expenses are tax deductible if a loan is related to the economic benefit of the company or it allows earning income, which is necessary for the company, regardless of that such income may be not taxed in accordance with the provisions of the Law on CIT.

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 are no such requirements from the point of view of the Law on CIT.

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

There are no such requirements.

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?

In Lithuania there is no difference between domestic and cross-border interest in respect of tax deduction.

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?)

There is no established provision in the Law on CIT regarding "deemed interest deduction" and there is no any court practise in respect of this. However, we consider that there may be a possibility to deduct such interest expenses using the principle "substance over the form", because any deemed interest on free loan actually creates deemed expenses on such interest, which may be deducted.

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, ...)?

In general, there are no special formal requirements. Ordinary documents, such as agreements, invoices, etc., are required in this case.

Transfer pricing documentation is required in associated transactions only provided that entity has an obligation to prepare a written transfer pricing documentation. According to the transfer pricing rules, the obligation to prepare such documentation applies to entities which meet at least one of the following criteria: (i) Lithuanian entities as well as foreign entities, the activities of which are carried out through a permanent establishment, if the income of the Lithuanian entity or income attributable to the foreign entity before the taxable year, when the transaction was in fact carried out, exceeded LTL 10 million (approximately EUR 2,898 million), (ii) financial companies and credit institutions, the activities of which are carried out according to the Law on Financial Institutions, and (iii) insurance companies, the activities of which are carried out according to the Law on Insurance.

The written transfer documentation should include: (i) information about the transaction parties, (ii) information about the controlled transaction (characterization of the subject matter of the transaction, its functional analysis and conditions, economic circumstances, business strategy), (iii) information about the transaction method used and comparability (benchmarking) analysis (brief information on how it was applied, what adjustments and calculations were made, what uncontrolled transactions were used, a functional analysis of the uncontrolled transactions, economic circumstances, business strategy (if possible)), and (iv) other information identifying sufficient circumstances concerning transfer pricing.

3.1.3. Thin capitalisation rules

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

In Lithuania thin capitalisation rules apply as from 1 January 2004.

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?

Thin capitalization rules apply, if the following conditions are met: (i) an entity has a "controlled debt" to a controlling entity; and (ii) entity's debt/equity ratio exceeds 4:1 at the end of the tax year; and (iii) an entity cannot substantiate that similar credit facilities (interest rate, other conditions, etc.) could be obtained from third parties. If the above conditions are met, interest payments with regard to the controlled debt in excess of the 4:1 debt/equity ration are not deductible.

Further, thin capitalization rules also apply to interest variable depending on the profits or turnover of the entity, as well as in other cases listed by thin capitalization regulations *(Interest payments related to profit, income or similar performance indicators (e.g. sales) of the entity and interest payable under debt-claims entitling the lender to exchange its right to interest with the right to the borrower's profit or a part thereof, also rent payments related to profit, income or similar performance indicators of the entity is qualified as unrelated to the earning of income and is not deductible from income of the Lithuanian entity).*

Lithuania does not apply debt/equity ratio based on EBIT, EBITDA and other similar performance indicators.

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

If by consolidation you mean consolidation on level of group companies, debt/equity ratio is applied on stand alone basis, i.e. on the basis of each company.

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

Thin capitalization rules apply to both domestic and cross-border situations.

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

Thin capitalisation rules also apply to intra-group loans (interest variable depending on the profits).

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.)?

Thin capitalisation rules apply to interest payments (mostly) and rent payments (rarely).

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. The ratio between debt and equity is calculated as of the last day of the taxable period of the Lithuanian entity.

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?

Yes, a contribution of shares or other assets into share capital of the borrower will increase a share capital and, accordingly, equity. In principle, the laws do not establish restrictions for increase of the equity of the borrower provided that such increase is made in accordance with the requirements of the Law on Companies. Normally, an increase may be made either by cash injection, conversion of the loan into capital or settlement of other monetary obligations or in-kind contribution.

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?

Thin capitalisation rules operate on stand alone basis, however, in case thin capitalisation threshold is exceeded, then transfer pricing documentation may be used in order to substantiate that conditions of the loan in question are in line with the conditions that would be established between third parties. Thus some interaction exist.

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?

As it is mentioned in section 3.1.3.2. above, interest payments with regard to the controlled debt in excess of the 4:1 debt/equity ration are not deductible for CIT purposes. There are no other penalties.

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

Entities deductions for interest are allowed on an accruals basis.

3.1.3.15 Please summarise your general rules?

Thin capitalization rules apply, if the following conditions are met: (i) an entity has a "controlled debt" to a controlling entity; and (ii) entity's debt/equity ratio exceeds 4:1 at the end of the tax year; and (iii) an entity cannot substantiate that similar credit facilities (interest rate, other conditions, etc.) could be obtained from third parties. If the above conditions are met, interest payments with regard to the controlled debt in excess of the 4:1 debt/equity ration are not deductible.

Further, thin capitalization also applies to interest variable depending on the profits or turnover of the entity, as well as in other cases listed by thin capitalization regulations. Thin capitalisation rules apply to both domestic and cross-border situations.

3.2. Withholding tax (WHT) on interest income 3.2.1.

General

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

Generally interest withholding tax is applicable on interest, except for interest on securities issued by the Government, interest accrued and paid on deposits, and interest on subordinated loans which meet the criteria set down by the legal acts of the Bank of Lithuania. Interest paid out by a resident entity to a non-resident entity is subject to 10% withholding tax.

Lithuania has been granted with a 6-year transitional period for the implementation of the Interest and Royalties Directive[1]. Therefore, interest and royalties paid to the associated enterprises covered by the Interest and Royalties Directive will be exempted from withholding tax as of 1 July 2011. During the period from 1 July 2009 to 31 June 2011 interest paid to such enterprises will be taxed at a 5% rate.

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 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 Lithuanian resident related companies Lithuanian rules might be not in line with ECJ case law.

3.2.2. Exemptions from WHT (internal law)

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

If interest is paid on securities issued by the Government, interest accrued and paid on deposits, and interest on subordinated loans which meet the criteria set down by the legal acts of the Bank of Lithuania, then no WHT is applicable.

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, including payments to banks. Currently, there is no exemption for interest paid to foreign credit institutions.

Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated entities of different Member States

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 3.2.2.1. above. The imposition of withholding tax is not subject to the effective taxation of the interest in the hands of the creditor. There is no other condition in regard to the identity of the lender except as mentioned in 3.2.2.1. above.

3.2.3. 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?

In general Lithuania sticks to the text of EU Interest & Royalty Directive (the **Directive).** The requirements for participation set out in article 3 (b) are the same as in the Directive (25%), including "indirect" shareholding and holding period, which is 2 years. Lithuania has used the right to apply the transitional periods established in article 6 (1) of the Directive. Please see 3.2.1.1.

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 concluded with Latvia 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 concluded with Latvia provides for a full exemption of withholding tax for interest, royalties and dividend payments to a Latvian tax resident corporation. 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?

Normally tax authorities 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 tax authorities.

3.2.3.6 Can you provide the General Reporters with on 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 Lithuanian taxation authorities regarding back to back arrangements and an acceptable spread.

In Lithuania it is impossible to obtain binding advance ruling. Currently, under Lithuanian law it is possible to obtain a non-binding ruling for tax matters. The tax authority must answer an enquiry within 30 days. Although rulings are not binding on the tax authority in case of a future tax audit, however, as it derives from the practice, the tax authorities conducting audits usually follow the interpretation given in the written opinion of the tax administrator. Further, such non-binding ruling provides protection against penalties.

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

3.3.1. How is interest income taxed at the level of the creditor? Interest income

increases a taxable base and is taxed as a normal income.

3.3.2. When is the interest income included in the creditor's taxable basis? It is recognized on

accruals basis.

3.3.3. 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 Lithuania on the same income. Any excess credit is lost.

3.3.4. 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?

Lithuanian has no rules which qualify interest income as dividend income. However, as it was mentioned in section 3.1.1.6. above, in this case an economic substance should be analysed in order to define whether amounts paid qualify as interest or dividends. If payments are treated as dividends, we consider that it might be possible to claim for participation exemption in such case.

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

Lithuania has no anti-double dip rules

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3.4. Recent developments

3.4.1. 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.

3.4.2. Are your rules expected to be changed significantly in the near future? We are not aware of possible significant changes.

3.5. Typical tax planning structures

3.5.1. 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.