

Dear client!

Riga  
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VIA E-MAIL

**Beware! Changes to the Latvian law on personal income tax can reclassify individuals working as independent self employed individuals or agents as employees. Your operational structure may have to change.**

From 1 January 2008 the Latvian personal income tax law introduces a reduced rate of personal income tax of 15% on the income earned by individuals through the performance of independent business activities.

The 15% rate is less than the standard personal income tax rate of 25% paid by individuals and is intended to only apply to individuals or professional persons who earn income through trading activities or the provision of services as an independent self employed person.

In order to prevent the possible mass conversion of existing employees to independent self employed persons and to clarify what income will be eligible for the 15% rate of tax, the Latvian personal income tax law has been further amended to list 6 specific criteria where if one exists, the income earned by the individual will be considered to be subject to "wages tax". As a result of such re-qualification the income may be subjected to 25% income tax instead of 15% income tax and additional social security contributions.

This change comes into operation on the 11<sup>th</sup> of December 2007 and is applicable to income earned from that date and may also effect existing personal services arrangements structured as independent contractor or agent agreements.

Presently, there is a significant difference in the amount of Latvian social security payable by a company when an individual is contracted as an employee compared to being contracted as an independent self employed person. Where an employee is paid a salary the employer must pay an additional 24.09% as an employer social security contribution based on the gross salary paid. Under a contractor or agent agreement a company does not have any employer social security contribution liability for the contracted individual.

Further, where the service arrangement is a contractor or agent agreement, a company is also not liable for the cost of holiday, sickness, maternity and other leave that would normally be provided to an employee.

These differences have lead to some personal services arrangements being structured as contractor or agent agreements and not employment agreements.

However, when these contractor or agent arrangements are objectively analysed, there is often not much to distinguish them from the terms and conditions and physical circumstances of an employment relationship.

Whilst the Latvian State Revenue Service (SRS) has in the past not sought to reclassify a contractor or agent arrangement as an employment arrangement the changes to the Latvian personal income tax law may allow the SRS, if one of the 6 criteria is established, to easily reclassify personal services arrangements which are presently structured as contractor or agent arrangements as employment arrangements.

An employment arrangement will be deemed to exist if **one** of the following six criteria is established as existing as part of the personal services arrangement between the individual and the client.

1. The individual taxpayer is financially dependent on the person to whom he or she is providing the service.
2. There is no financial risk of the work being performed unprofitably or the incurring of losses through bad debts.
3. The individual taxpayer is integrated into the organisation that he or she is providing services to. Integration means the existence of a place of work or rest within the organisation and the obligation to observe the organisations internal operational rules and other similar indicators.
4. The actual holidays and vacation utilised by the individual taxpayer and the procedure by which they are determined are in accordance with internal work procedures established by the organisation or another organisations employee work timetable.
5. The individual taxpayers work is under the control or supervision of another person and the individual is not allowed to use the services of other personnel or subcontractors.
6. The individual taxpayer is not the owner of fixed assets, materials or other income producing assets (this does not apply to a personal motor vehicle or personal items used in the performance of the services provided).

We strongly recommend that if your company has existing contracts with independent self employed individuals or agents that you review these arrangements to ensure that none of the six criteria detailed above can be applied to the arrangement. If you have been approached by existing employees to enter into an independent contractor or agent agreement you will also need to ensure that if the agreement is entered into, none of the 6 criteria exist in the arrangement.

When an individual receives income that is subject to wages tax it is the responsibility of the payer of the income to withhold the wages tax and employee social security contribution and also make an employer's social security contribution. Failure to do so can result in taxation penalties. There can also be penalties for non registration of the individual as an employee, entering into an employment arrangement without an employment agreement and other acts of administrative non compliance.

Accordingly, it is now essential that when a personal services agreement has been entered into the provider of the service and the recipient of the service can both show that none of the

six criteria exists in the arrangement. If this cannot be done, then to avoid potential penalties, we suggest the arrangement should be entered into on an employer - employee basis.

We would be pleased to assist you in determining whether existing contracts or proposed contracts are at risk of not being accepted by the Latvian taxation authorities as contracts for the provision of independent contractor or agent services, the payments for which will not be subject to wages tax.

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