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TAX NEWSFLASH

On May 17 the Latvian parliament passed and on May 29 the official gazette published a number of amendments to various laws as a part of the campaign to reduce the current rate of inflation in Latvia. The amendments become effective on 12 June 2007, except the provision for a sale of real estate where the transitional period is granted up to 1 July 2010 as explained below.

1. SALE OF REAL ESTATE

1.1. Individual income tax law changes

One of suggested causes of the current inflation is the overheated property market allegedly caused by the personal income law allowing the profit on the sale of real estate that had been owned by individuals for more than 12 months to be tax free. As a result, few changes to the personal income tax law have been passed to restrict the situations where the sale of real estate owned by individuals will be tax free.

1.1.1. ”Sale” changed to “alienation”

Thus, the previously used phrase “income from the sale of real estate” was changed by replacing the word “sale” with the word “alienation” (the transfer of title to real estate). As a consequence, the wider range of transactions transfering title to real estate will be subject to income tax.

1.1.2. Sale of shares also qualify as real estate

Moreover, due to the changes in the law the alienation of real estate is now defined to also include the sale of shares in a company which in the year of alienation or the pervious year had more than 50% of its assets directly or indirectly consisting of real estate located in Latvia. This definition applies to qualifying share sales by both resident and non resident taxpayers. As of the end of last year a sale of real estate already included a sale of those shares where real estate was contributed into the share capital.

1.1.3. One year changed to five to qualify for the exemption

Furthermore, income from the alienation of real estate (land or qualifying shares) is now exempt, where the physical real estate has from the date the owner was registered in the Land Book Register been owned for 60 months and has for the 12 months prior to finalisation of the alienation agreement been declared as the primary residence of the registered owner and not as a supplementary address. This is later referred to as the “5+1 rule”.

(a) Interpretation of ”primary residence”

Obviously, declaring a residence address on a bare land plot would not be possible, thus land plots are authomaticaly excluded from the exemption. In practice declaration mostly means the state and municipal entities can contact you at the address. A person with more than one property could live in one but still be declared at several other places, however only one address can be registered as a primary one. Apparently there is no penalty for declaring at a property you own but living at another. However, in theory another aspect when interpreting the meaning of residence is the Civil code which states that the place of residence (domicile) is where a person lives with an intention to be there permanently, and a temporary living does not create legal consequences of a residence.

1.1.4. Transitional period up to 1 July 2010

The changes to the law also provide for transitional provisions that will allow certain real estate to be sold up to 1 July 2010 (generally – if ownership to the property was registered with the Land Book Register on 12 June 2007) and still be treated as exempt in accordance with the law that existed prior to these changes (1 year rule).

1.1.5. No transitional period for sale of qualifying shares

Whilst the above will allow a deferral of the application of the 5+1 ownership requirement to physical real estate the transitional period does not allow to grant a deferral date to the sale of qualifying shares. Thus a sale of qualifying shares as of 12 June 2007 generally will be taxable.

1.1.6. Sale of fixed assets - taxable

A sale of real estate which has been used by an individual for income producing purposes (and booked as a fixed asset) and is sold whilst still be used as such will be subject to tax as part of that income producing activity.

1.1.7. Reclassification to personal use – tax depreciation creates taxable income

If the real estate ceases to be used for income producing purposes and is reclassified as personal property, if it is later sold as exempt real estate because after reclassification the 5+1 rule has been complied with, all the depreciation for tax purposes that had been claimed during its prior use for income production is retrospectively disallowed and is to be declared as income in the year of sale.

1.2. Corporate income tax law changes

Under the Corporate income tax law non residents who sell Latvian real estate are subject to a 2% withholding tax on the total value of the sale proceeds. The 2% withholding tax now also applies to the sale of shares in a company which in the year of alienation or the pervious year had more than 50% of its assets directly or indirectly consisting of real estate located in Latvia.

2. COMPANY OWNED LUXURY MOTOR VEHICLES

The type of passenger vehicle that can be used by a company in its business and qualify for tax deductions has now been restricted in the law with the result that Bentleys, Rolls Royces, Ferraris, BMW and other luxury cars in most cases no longer

qualify as company vehicles (unless they are purchased before 12 June 2007, in which case the new provisions do not apply). A vehicle will not be qualified for tax deductions if it meets the following criteria:

(a) it has less than 8 seats excluding the driver,

(b) its value including VAT, is more than ~ LVL 30,000 (EUR 43,000),

(c) it is not designed for use as a specialised transport vehicle or has not been modified to operate as such, or

(d) is not a demonstration vehicle used by a dealer of the particular vehicle make.

The deductions now specifically excluded by the law are all expenses associated with the use and maintenance of a non qualifying (luxury) vehicle as well as the rental or lease expenses of a non qualifying vehicle. If a vehicle is a qualifying vehicle and is used in the company's business but after is repaired, restored or reconstructed, and its value for taxation purposes increases above the said LVL 30,000, the vehicle will become a non qualifying vehicle and depreciation will not be claimable from the year the value increased. The income from the sale of a non qualifying vehicle is not taxable income if tax depreciation has not been claimed in regard to the vehicle.

Apart from the changes relating to luxury cars, few changes are made in respect of other types of vehicles. Thus, from 12 of June 2007 the depreciation of vehicle value must be calculated using factor 1,5 instead of previously used factor 2.

3. CONTROLS OVER THE ISSUING OF LOANS

3.1. Consumer Rights Protection Law changes

The changes to this law now require a provider of consumer credit to only issue a loan that is equal or more than 100 times the legislated minimum wage (currently LVL 120) after obtaining proof of the applicant's income by receiving a State Revenue Service certification or similar document issued by the taxation authorities. Moreover, consumer loans for more than LVL 12,000 can only be granted if at least a 10% deposit has been paid. Loans for the purchase of real estate are limited to 90% of the market value of the property.

3.2. Credit Institutions Law changes

Due to changes in this law, credit institutions are required to notify the State Revenue Service of income earned by a taxpayer on his/her deposit account as required by the law on Individual income tax. Moreover, now the penalty of LVL 1,000 may be imposed on those credit institutions that lend money to purchase real estate for more than 90% of its market value or lend money where the required 10% initial payment has not been made. If the offence is repeated within one year a penalty of LVL 3,000 is payable.

4. OTHER CHANGES

There have also been changes to the rate of duty applied to the first registration of motor vehicles with an engine capacity greater than 3,000 cubic centimetres which

ranges from LVL 300 to LVL 600 for engines with a capacity greater than 4,500 cubic centimetres.

Furthermore, the period, after expiration of which a natural person can sell the forest for the purposes of cutting it down or for getting timber products tax free, was extended from 12 months to 36 months.

Should you have any questions regarding this tax news, please feel free to contact us.

Yours sincerely,

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