



## **Lex Mundi European Union: Accession States Tax Guide**

### **LATVIA Klavins & Slaidins**

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#### **A. General information**

Latvia has one of the fastest growing economies in the European Union. Since 2001 the GDP rate has grown on average by more than 8% per year. It is estimated that the GDP growth rate for 2006 exceeded 10%. Latvia has a competitive tax system, with a low corporate tax rate of 15% and a broad tax treaty network (more than 40 effective treaties). The government encourages foreign investment and is continuously working towards improving the investment climate, including improving the taxation system. Significant steps have been taken to improve the quality and effectiveness of the administration of the taxation system. The State Revenue Service is actively working to increase the rate of voluntary tax revenues, improve taxpayer services and increase controls for combating fraud. Tax revenues have consistently increased in recent years. In 2006 the revenues increased by 29.3% compared to 2005 reaching LVL 3.44 billion.

#### **B. Corporate income taxation**

##### **1. Which are the taxable entities?**

Resident companies, certain state and municipal financed institutions, and non-residents are subject to Latvian corporate income tax. Resident companies are taxed on their world-wide income while non-residents are taxed on their Latvian source income.

## 2. How is the taxable income determined?

Taxable income is determined based on the taxpayers financial income for the given period subject to certain adjustments. Companies can reduce taxable income by the following:

- Tax depreciation expenses;
- Real estate tax, lottery and gambling tax, state fees for organizing goods or services lotteries;
- Certain EU or state subsidies paid for agriculture development;
- Bad debts (subject to certain restrictions)
- Certain income recorded in relation to the privatization of enterprises
- Reductions in reserves which previously were included in taxable income;
- The book value of computer equipment (including printers) donated to educational institutions for no consideration;
- Income from the sale of publicly traded securities;
- Premiums paid to Latvian or EU registered insurance companies and payments made into employee pension funds (subject to certain limitations.)

Companies must increase their taxable income by the following:

- Expenses incurred for the maintenance of the company's social infrastructure, i.e. housing, educational, sports, catering and health care institutions if their services are provided below market value or if they are not directly linked to the business of the company;
- Depreciation and amortization expenses as calculated for the financial accounts;
- Penalties, fines and late-payment interest;
- Uncompensated amounts arising from deficits and theft in companies with more than 50% state or municipal ownership;
- Payments to non-residents subject to withholding tax for which withholding tax was not charged;
- 40% of representation expenses;
- Acquisition costs of long-term investments, excluding non-capitalized interest paid on long-term debt and on repayable debt; certain reserves;
- Fines paid for the excessive exploitation of natural resources or excessive pollution;
- Losses arising from the sale of publicly traded securities (excluding losses carried forward);
- Expenses incurred on the acquisition of publicly traded securities;
- Interest payments in excess of allowable amounts.

## 3. What are the applicable tax rates?

There is a flat rate of 15%.

## 4. Are capital gains taxed separately?

Capital gains are taxed as ordinary income.

## 5. May losses be carried back or forward and to what extent?

Tax losses can be carried forward (chronologically) for a period of five years. In case of a change of control and a change in the main operating profile of a company, the ability to carry forward any accrued losses is lost. Losses from the sale of securities (other than publicly traded securities) can be brought forward chronologically for a period of five years but can only be used to offset income from the sale of securities (other than publicly traded securities.)

## 6. Are there any withholding taxes and at which rates?

The following payments made to non-residents are subject to withholding tax according to domestic law. In some cases effective double tax treaties may reduce or eliminate the withholding tax.

Dividends paid to non-residents are subject to 10% withholding tax. Withholding tax is not applicable in case the recipient is located in a European Union member state or European Economic Area and has held continuously for two years at least 15% (10% from 2009) of the capital and voting shares in the Latvian resident company making the payments.

Withholding tax at a rate of 10% (5% for Latvian registered banks) is applicable to interest payments made to non-resident associated persons. From 2009 the rate will be reduced to 5% and from 2013 no withholding tax will be applicable for interest payments made between related parties located in the European Union.

Royalties paid to non-residents are subject to withholding tax at a rate of 15% for copyrights to literary and art works or 5% for all other types of intellectual property. Until 30 June 2009 the rate is reduced to 10%, from 1 July 2009 until 30 June 2013 the rate will be 5% and from 1 July 2013 no withholding tax will be applicable to payments made to a company located in the European Union for copyrights to literary and art works. The 5% rate will remain for all other types of intellectual property.

|  |     |
|--|-----|
| Management and consulting fees   | 10% |
| Payments for the use of property located in Latvia (moveable and immoveable) | 5%  |
| Proceeds from the sale of real estate  | 2%  |
| Partnership distributions  | 15% |
| Payments to statutory low tax zones  | 15% |

## 7. Are there any preferential group taxation rules in force?

According to Latvian law it is possible to transfer losses between companies in the same group subject to certain requirements and restrictions. The general requirement is 90% direct or indirect ownership. In order to be able to transfer the losses the following criteria must also be met:

- 1) The companies are resident in Latvia or an EU member state or country with which Latvia has concluded a double tax treaty;
- 2) The companies are members of the group for the entire period when the losses were incurred;
- 3) The companies have the same tax periods ending on the same date (financial year);

- 4) None of the companies are exempt from corporate income tax or utilizes a reduced rate of income tax;
- 5) None of the companies have any outstanding tax liabilities (debts);
- 6) The companies have their annual accounts audited/certified by a sworn auditor.

**8. Which are the anti-avoidance rules currently in force?**

Withholding tax of 15% is applicable to payments (subject to limited exceptions) made to statutory designated offshore zones unless express permission is obtained from the tax authorities to make payments without charging the tax.

Transfer pricing rules are applicable to transactions carried out between related parties. If goods or services are sold between related parties at prices above or below fair market value, the State Revenue Service could require that taxable income is adjusted by the difference between the actual value of the transactions and the fair market value.

Thin capitalization rules are applicable to companies that incur interest expenses limiting the amount that can be deducted for corporate tax purposes. Effectively a 4:1 debt/equity ratio is applied according to a specified formula. The thin capitalization rules are not applicable to interest expenses incurred for loans issued by Latvian or EU registered credit institutions.

**9. Which are the main administrative requirements to comply with the local tax authorities?**

Taxpayers should ensure that filing deadlines are complied with.

- Annual corporate income tax return within 4 months (or 7 months) after the end of the financial year
- Report of payments to non-residents by the 15<sup>th</sup> date of the month after the tax period
- Report of payments to related parties by the 15<sup>th</sup> date of the month after the tax period
- Other types of returns are generally due on the 15<sup>th</sup> date of the following month.

It is important that all transactions are properly documented, and the relevant supporting documents are available in Latvia. Accounting must be carried out in accordance with the requirements of Latvian law and should be available in the Latvian language.

**10. With which countries have double taxation conventions already been concluded?**

Please see attached schedule for effective double tax treaties.

**11. Are there any special laws providing tax incentives to certain taxable entities?**

Companies that carry on certain agricultural activity are eligible to receive limited tax relief. Companies operating in special economic zones or freeports may be eligible to receive tax breaks of up to 80% of corporate income tax, real estate tax as well as special rules applicable to certain transactions for VAT purposes.

## **C. Individuals**

### **1. Which are the taxable persons?**

Residents and non-residents are subject to taxation in Latvia. Residents are taxed on their worldwide income while non-residents are taxed on their Latvian source income or income received with respect to certain activities carried out in Latvia or on behalf of a Latvian company. Individuals are deemed to be residents if they permanently reside in Latvia or if they spend more than 183 days during any twelve month period which begins or ends within the taxation year.

### **2. How is the taxable income specified?**

Taxable income includes income from employment, professional activities, business activities, real estate, intellectual property, benefits received from an employment relationship, and other income which is not exempt. Individuals are entitled to claim certain allowances for dependents including, medical and education expenses, donations to approved organizations, health and life insurance premiums and social insurance contributions paid. Certain types of income (subject to certain limitations) are exempt including dividends from Latvian or EU resident companies, income from deposits in Latvian or EU registered banks, life or health insurance benefits, alimony, certain stipends, inheritances, income from investments in private pensions funds and gifts from natural persons.

### **3. What are the applicable tax rates?**

Personal income tax is charged at a rate of 25%. From 2008 there will be two rates, the 25% rate will remain but income from business activity carried out by individuals will be subject to a 15% rate.

### **4. Are capital gains taxed separately?**

Capital gains are treated as ordinary income. As a general rule capital gains incurred by individuals are exempt from tax (subject to limited exceptions) provided the gains were not incurred from business activity.

### **5. May losses be carried forward or back?**

Losses incurred by individuals from business activity can be carried forward chronologically for a maximum period of three years.

## **D. Capital**

There are no separate taxes on gifts, capital or inheritances.

Real estate is subject to real estate tax at a rate of 1.5% of the cadastral value of land and buildings.

## **E. Indirect taxes**

### **In outline, which are the main indirect taxes, if any?**

Value added tax- The supply of goods and services are subject to VAT. The general rate of VAT is 18%, reduced rate of 5% and 0%. Latvian VAT legislation generally follows EU requirements.

Excise tax – Certain excised goods are subject to excise tax including tobacco, alcohol and oil products. The rates of excise tax vary depending on the particular type, content and form of the goods.

Import duties - Latvia applies EU customs law and goods imported into Latvia are subject to EU customs requirements and tariffs.

Natural resource tax – Persons that carry on polluting activity, use natural resources or use packaging are subject to natural resource tax. The rates of tax depend on the particular type of activity and the extent of such activity.

Light automobile and motorcycle tax – Tax is payable upon the registration of a light automobile or motorcycle. The rates of tax depend on the age of the vehicle.

Transfer taxes – There are no transfer taxes on the transfer of assets, shares or capital. However, there is a state fee payable for the registration of title to real estate. The fee for the sale of real estate is 2% of the transaction value subject to a cap of LVL 30,000.

## **F. Other duties**

State fees – Various activities and services carried out by state institutions are subject to the payment of state fees. The fees are applied to such activities as company registration, obtaining certain types of information from public registers, filing documents with public registers and others. The fees vary depending on the type of activity to be carried out but generally are not material.

## **G. Enforcement- Litigation procedure**

### **1. In outline, which are the existing measures in order to ensure compliance with the tax legislation?**

The State Revenue Service is given relatively broad powers to ensure taxpayer compliance and can carry out various types of inspections and audits, as well as request information, documents and explanations from taxpayers. In certain cases the State Revenue Service can suspend the operations of a company, freeze its assets and bank accounts. Failure to comply with tax regulations can result in fines and penalties of up to 200% of tax liability due in addition to late fees and interest.

Latvia

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Formally, the State Revenue Service enforces tax compliance through the issuance of administrative acts. A decision issued by the State Revenue Service in the form of an administrative act must first be appealed through the general director and only then can the appeals process continue in the court process. In most circumstances a tax dispute would be resolved in the administrative court system which consists of two levels. There are no specific tax courts that hear tax disputes.

Subject to certain restrictions Latvian law also provides for a settlement procedure to resolve tax disputes.

**2. What is on average the duration of the litigation procedure for the final resolution of tax disputes?**

The duration of the litigation process to obtain the final resolution of a tax dispute can take from several months up to two or even three years.

**INCOME TAX RATES**

| <b>Corporations</b> | <b>Partnerships</b>            | <b>Individuals</b> | <b>Other entities</b>  |
|---------------------|--------------------------------|--------------------|--|
| 15%                 | Not taxed at partnership level | 25%                | Other types of entities which carry out business activity would generally be subject to corporate income tax at a rate of 15%. |

**LIST of DTC AGREEMENTS**

| <b>Country</b> | <b>Dividends<sup>1</sup>%</b> | <b>Interest %<sup>2</sup></b> | <b>Royalties<sup>3</sup>%</b> |
|----------------|-------------------------------|-------------------------------|-------------------------------|
| Armenia        | 15/5                          | 10                            | 10                            |
| Azerbaijan     | 10/5                          | 10                            | 5/10                          |
| Belarus        | 10/10                         | 10                            | 10                            |
| Belgium        | 15/5                          | 10                            | 5/10                          |
| Bulgaria       | 5/10                          | 5                             | 7/5 <sup>4</sup>              |
| Canada         | 15/5                          | 10                            | 10                            |
| China          | 10/5                          | 10                            | 10                            |
| Croatia        | 10/5                          | 10                            | 10                            |
| Czech Republic | 15/5                          | 10                            | 10                            |
| Denmark        | 15/5                          | 10                            | 5/10                          |
| Estonia        | 15/5                          | 10                            | 5/10                          |
| Finland        | 15/5                          | 10                            | 5/10                          |
| France         | 15/5                          | 10                            | 10/5                          |
| Germany        | 15/5                          | 10                            | 5/10                          |
| Georgia        | 5/10 <sup>5</sup>             | 10                            | 10                            |
| Greece         | 5/10                          | 10                            | 5/10                          |
| Hungary        | 5/10                          | 10                            | 5/10                          |
| Iceland        | 15/5                          | 10                            | 5/10                          |
| Ireland        | 15/5                          | 10                            | 5/10                          |
| Israel         | 10/15                         | 5/10                          | 5                             |
| Kazakhstan     | 15/5                          | 10                            | 10                            |
| Lithuania      | 15/0                          | 0                             | 0                             |
| Luxembourg     | 10/5                          | 10                            | 5/10                          |
| Malta          | 10/5                          | 10                            | 10                            |
| Moldova        | 10/10                         | 10                            | 10                            |
| Netherlands    | 15/5                          | 10                            | 5/10                          |
| Norway         | 5/5                           | 10                            | 5/10                          |
| Poland         | 15/5                          | 10                            | 10                            |

| Country         | Dividends <sup>1</sup> % | Interest % <sup>2</sup> | Royalties <sup>3</sup> % |
|-----------------|--------------------------|-------------------------|--------------------------|
| Portugal        | 10/10                    | 10                      | 10                       |
| Romania         | 10/10                    | 10                      | 10                       |
| Serbia          | 5/10                     | 10                      | 5/10                     |
| Singapore       | 10/5                     | 10                      | 7.5                      |
| Slovak Republic | 10/10                    | 10                      | 10                       |
| Slovenia        | 15/5                     | 10                      | 10                       |
| Spain           | 5/10                     | 10                      | 5/10                     |
| Sweden          | 15/5                     | 10                      | 5/10                     |
| Switzerland     | 15/5                     | 10                      | 5/10                     |
| Turkey          | 10/10                    | 10                      | 5/10                     |
| Ukraine         | 15/5                     | 10                      | 10                       |
| United Kingdom  | 15/5                     | 10                      | 5/10                     |
| USA             | 15/5                     | 10                      | 5/10                     |
| Uzbekistan      | 10/10                    | 10                      | 10                       |

<sup>1</sup> Under most treaties the rates differ according to whether the dividends are paid to a qualifying company/person or not. The first rate is for a non-qualifying company/person and the second rate is for a qualifying company. As a general rule in order to be a qualifying company under the treaties a company must have at least 25% of the Latvian company's voting or share capital as the case may be. In the case of France and Israel the holding requirement is 10%.

<sup>2</sup> In some cases the withholding on interest may not apply if interest is paid to certain government or institutions or government backed loans.

<sup>3</sup> The reduced rates for royalties generally apply to equipment leasing.

<sup>4</sup> Rate varies according to the type of royalty being paid.

<sup>5</sup> Qualifying company requires also a minimum investment equivalent to USD 75,000.