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Ministry Proposals Address Interest Paid to Nonresidents

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COUNTRY DIGEST

Ministry Proposals Address Interest Paid to Nonresidents

Latvia's Finance Ministry on March 31, 2009, will submit to the Cabinet of Ministers proposed amendments to bring the Law on Corporate Income Tax into line with EU law, specifically regarding rules on the deductibility of interest paid to nonresidents.

The proposals are being drafted in response to a June 5 notice from the European Commission notifying Latvia of the discriminatory nature of the rules. Latvia adopted a response to the notice on July 29, acknowledging that the provisions at issue are incompatible with EU law and confirming that the corporate tax law will be amended accordingly.

Discriminatory Rules

Article 64 of the law establishes rules regarding the adjustment of taxable income for interest payments (thin capitalization rules). It says an entity's taxable income will be increased:

- by interest payments that exceed the amount calculated by applying to a loan the last month's short-term credit rate (at credit institutions specified by the Central Statistics Bureau) for the tax period, multiplied 1.2 times (the amount of interest included in expenditures for economic activities may not exceed the actual calculated amount of the interest payments); and
- by interest payments that exceed the average amount of debt obligations in the tax period on which the interest payments are calculated, which is equal to the fourfold amount of equity reflected in the taxpayer's annual accounts (at the beginning of the tax period). Calculations of the equity will be reduced by the revaluated reserve of long-term investments and other reserves that have not been created as a result of the division of profits.

If both of the conditions apply to an entity's interest payments, its taxable income will be increased by the greater amount, as calculated in accordance with article 64.

However, paragraph 4 of article 64 provides for an exemption. It says the thin capitalization rules do not apply to credit institutions and insurance companies or to interest payments for credits, leasing services, and loans provided by credit institutions registered in the Republic of Latvia or in another EU member state or by the Latvian Treasury, the Nordic Investment Bank, the World Bank, or by residents of the Republic of Latvia.

The discriminatory aspect of the law is that the exemption does not apply to residents of another EU/European Economic Area member state, only to residents of the Republic of Latvia. This violates EU law, particularly articles 49 and 56 of the EC treaty and articles 36 and 40 of the Agreement on the European Economic Area, all of which deal with the freedom to provide services and the free movement of capital.

Latvia acknowledges the violation in its response to the commission's formal notice, but also pointed out that the European Court of Justice's judgment in *Test Claimants in the Thin Cap Group Litigation* (C-524/04) may not be applicable in Latvia's case, as there are no objective criteria that can be used to establish (recognize) wholly artificial arrangements for tax purposes. (For the ECJ judgment in *Test Claimants in the Thin Cap Group Litigation*, see *Doc 2007-6302* or *2007 WTD 50-9*.)

The commission does not mention such criteria in its communication to the European Council, the European Parliament, and the European Economic and Social Committee on ''the application of antiabuse measures in the area of direct taxation within the EU and in relation to third countries'' (COM (2007) 785), although the existence of such criteria would help EU member states ensure that their national tax laws are in compliance with the fundamental freedoms of the EC Treaty and the EEA Agreement while at the same time preventing tax avoidance. One of the main aims of Latvia's thin capitalization rules is the prevention of tax avoidance.

Conclusion

Notably, article 64 was implemented into Latvia's corporate income tax law on June 19, 2003, at which time the exemption from the thin capitalization rules applied only to credit institutions and insurance companies and to interest payments for loans received from credit institutions registered in Latvia. On December 20, 2004, the exemption was extended to interest payments for loans received from credit institutions registered in other EU member states and to the World Bank, and on October 20, 2005, it was further extended to the Latvian Treasury and the Nordic Investment Bank. The exemption from the thin capitalization rules for interest payments on loans received from residents of the Republic of Latvia did not come into force until January 1, 2007.

It is clearly established by ECJ case law that although EU member states enjoy sovereignty in the area of direct taxes, they still must comply with EU law. At the same time, there are no common rules to establish how the member states can achieve both goals of sovereignty and compliance. The ECJ and the European Commission have tried to establish a framework, but the rules are too broad and vague, and there is still much uncertainty between EU member states and also between participants in the common market.

To bring its domestic law into compliance with EU law, Latvia says it will apply the same tax treatment to interest payments made to EU/EEA residents and to residents of Latvia. However, it is unclear whether that means the existing exemption will also be applied to EU/EEA residents or that the thin capitalization rules will be applied to residents of Latvia, making the domestic tax rules more stringent than before. ◆

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