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Latvia

by Valters Gencs

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2008
YEAR IN REVIEW

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THE YEAR IN REVIEW

Latvia

by Valters Gencs

The main tax development of the year involved controversial amendments to the rules for mandatory social security contributions.

Under prior law, the maximum tax base for mandatory social security contributions was LVL 29,600 per year, which corresponds to roughly €42,117. That limit remained in effect for 2008. Amendments approved during the year, however, remove the limitation from January 1, 2009, through December 31, 2013. Taxpayers will have to pay social security contributions at the prescribed rate regardless of their annual income.

In 2008 Latvia's tax treaties with Italy and Kyrgyzstan entered into force. Both treaties will be applied from January 1, 2009. The treaty with Italy was signed in 1995, and it appeared to be going nowhere until Italy made amendments in 2004 allowing ratification to proceed. Latvia now has tax treaties with all EU member states except Cyprus. Latvia has 47 treaties in force.

Latvia signed treaties in 2008 with South Korea and Morocco. The treaty with South Korea was initialed in 1999. The Ministry of Finance initialed new treaties with Turkmenistan, Tajikistan, and Tunisia in 2008 and held the first round of treaty negotiations with Mexico.

It's expected Parliament will approve more changes in late December as part of the 2009 budget law. The anticipated changes include an incentive to increase retained earnings. Net corporate profits may be either reinvested or distributed to shareholders. Currently there is no tax incentive for retaining earnings. Retained earnings are effectively discouraged by the fact that dividends are exempt from tax in Latvia.

A proposal in the budget would allow companies to deduct from taxable income an amount equal to the interest expense on a hypothetical bank loan in an amount equal to annual retained earnings. In theory, companies could lower their tax burden by paying fewer dividends.

Another budget measure would encourage aircraft leases with nonresidents. Lease payments to nonresidents for the use of aircraft would no longer be subject to withholding. Other changes would benefit taxpayers that made significant investments in production facilities that cannot be recovered within a five-year period and would extend the loss carryforward period from five years to eight years.

The budget also responds to an alleged EU infringement matter. In February 2008 the European Commission notified Latvia that it had not fulfilled its obligations under article 56 of the EC Treaty and article 40 of the European Economic Area Agreement. Latvia's personal income tax law requires withholding on dividends paid to residents of EU or EEA member states, but requires no withholding on dividends paid to Latvian residents.

The government disagrees with the commission, but plans to make the necessary amendments to the personal income tax law to avoid further complications. The new provision should be in full compliance with EU law.

The government may also reconsider dividend taxation in 2009. ◆

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