LAW FIRM
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In this issue:

LATVIA
Interest Payments

LATVIA
Possible New Tax Incentives

ESTONIA
Taxation benefits in Estonia in 2009

LITHUANIA
Competition

GENCS VALTERS LAW FIRM

is pleased to announce its arrival in Vilnius, Lithuania

The Official Opening reception of office in Vilnius is scheduled at March 6, 2009 at 19:00 in Crowne Plaza Hotel.

Competition

In case of concentration or merger it is obligatory to obtain permission from the Competition Council. Concentration is also when a new undertaking is established from two or more businesses, as well as when one or more undertakings gain control over another undertaking by acquiring an enterprise or part of it, all or part of assets, shares, securities, voting rights. In case the total income of the entities during the previous financial year exceeds LTL 30 million (approx. 10350000 EUR) and each of two legal entities have total income more than LTL 5 million (approx. 1725000 EUR), market participants which have decided to merge prior a merger shall submit a notification to the Competition Council.

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Changes Regarding Taxation of Interest Payments

Introduction

On 5th of June 2008 the European Commission sent to Latvia a letter of formal notice regarding its discriminatory rules on the deductibility of interest paid to non-residents.

In response to this formal notice on 29th July 2008 there was adopted Latvia`s position where it admitted that the respective provisions of the law "On Corporate Income Tax" (hereinafter- the Law) are incompatible with the EC law and that amendments into the Law will be submitted to the government till 31st March 2009.

Discriminatory Rules of the Law

The Article 6[4] of the Law establishes rules regarding adjustment of taxable income for interest payments (thin capitalisation rules). According to this article there are two cases when the taxable income shall be increased:

1) by interest payments which exceed the amount of interest payments, which is calculated by applying to a loan the previous month's short-term credit rate in credit institutions specified by the Central Statistics Bureau for the taxation period and multiplied 1.2 times. (The amount of interest included in the expenditures for economic activities may not exceed the actual calculated amount of interest payments);

2) by interest payments in proportion to the amount to which the average amount of debt obligations in the taxation period (in respect of which the interest payments are calculated) exceeds the amount, which is equal to the fourfold amount of equity reflected in the taxpayer's annual accounts (at the beginning of the taxation period). Calculations of the equity shall be reduced by the revaluated reserve of long-term investments and other reserves, which have not been created as a result of the division of profits.

If at the same time the taxable income shall be increased accordingly to the both above-mentioned cases the taxable income shall be increased by the greatest amount which has been calculated in accordance with the above-mentioned rules.

However, the paragraph 4 of the same Article provides for an exemption. It is settled that the above-mentioned rules do not apply to credit institutions and insurance companies, as well as to interest payments for credits, leasing services and loans, which are received from credit institutions registered in the Republic of Latvia or in another Member State of the European Union, the Latvian Treasury, the Nordic Investment Bank or from World Bank group, as well as from residents of the Republic of Latvia (the present wording of that paragraph). The exemption is not applied to EU/EEA residents.

It shall be noted that the Article itself was implemented into the Law on 19th of June 2003 and at that time the exemption from those thin capitalisation rules was applied only to credit institutions and insurance companies, and to interest payments for loans received from credit institutions registered in Latvia. Later (on 20th of December 2004) the exemption was extended to interest payments for loans received from credit institution registered in other EU Member State and to the World Bank group, but on 20th of October 2005 to the Latvian Treasury and the Nordic Investment Bank.

It shall be noted that exemption from thin capitalisation rules to interest payments for loans received from any resident of the Republic of Latvia became into force only on 1st January 2007.

It is obvious that such exemption which applies only to interest payments for loans received from Latvian residents contradicts the EC law, especially the Articles 49 and 56 of the Treaty Establishing the European Community (hereinafter-EC Treaty) as well as the Articles 36 and 40 of the Agreement on the European Economic Area (hereinafter-EEA Agreement). This is also acknowledged in the Latvia`s position to the Commission`s formal notice. However, at the same time in its position Latvia underlines that an interpretation of the European Court of Justice (hereinafter-ECJ) in its judgement regarding *Thin Cap Group Litigation* case (C-524/04) may not be explicitly applicable as there do not exist any objective criteria which could be used in order to establish (recognise) wholly artificial arrangements for taxation purposes.

The Commission is also not presenting such criteria in its communication "The application of anti-abuse 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 for EU Member States to ensure that their national tax laws are in a compliance with the fundamental freedoms of the EC Treaty and EEA Agreement and at the same time to secure against avoidance from the taxation. It shall be noted that one of the main aims of thin capitalisation rules is prevention from avoidance of the taxation.

Conclusion

It shall be remembered that it is clearly settled by the ECJ case-law that although EU Member States enjoys sovereignty in direct tax area they must nevertheless exercise it in compliance with the EC law. At the same time there do not exist any common rules how this compliance shall be exercised. The ECJ and the Commission have tried to establish some framework and rules, but however those rules are too broad and vague and therefore there exists uncertainty between EU Member States as well as between market players.

In order to bring the Law in compliance with the EC law Latvia in its position has stated that it will make amendments into the Law and will apply the same taxation regime in respect of interest payment paid to EU/EEA residents and residents of Latvia. However, it is not known whether it means that the existing exemption will be applied also to EU/EEA residents or thin capitalisation rules will be applied also to residents of Latvia and thus making the taxation rules more stringent than before.

Possible New Tax Incentives

At the beginning of this year discussions about new tax incentives for companies in Latvia were started. In April by the resolution of the Prime Minister the Ministry of Finance and the Ministry of Economics established a working group with an aim to elaborate proposals for amendments in Corporate Income Tax Law as well as Real Estate Tax Law. In the working group have taken part also representatives from non-governmental sector like the Employers` Confederation of Latvia and the Latvian Chamber of Commerce and Industry. Moreover there was concluded an agreement with few companies regarding calculation of impact of corporate income tax and real estate tax and possible new tax incentives on companies` business results.

Present Tax Incentives

It shall be said that in general Latvian corporate income tax is quite simple, with wide taxable base, low tax rate and it is in compliance with EU fundamental freedoms as well as with state aid rules. Wherewith, the administration of corporate income tax is relatively cheap.

At the moment there exist few substantial corporate income tax incentives which are envisaged for attraction of investments:

1. Low corporate income tax rate

Since 2004 corporate income tax rate is 15% which is one the lowest corporate income tax rates in the European Union. There is 15% corporate income tax rate also in Lithuania, but in Ireland 12,5%, Cyprus 10% and in Bulgaria 10%.

It shall be noted that the real burden of corporate income tax is showed by the effective tax rate which in 2006 was approximately 10.2% in Latvia but in Lithuania approximately 12,5%, in Ireland approximately 10%.

2. Special Tax regime in Special Economic Zones and Free Ports

There is established a special tax regime in some special economic areas (Rezekne Special Economic Zone and Liepaja Economic Zone) and free ports (Ventspils Free Port and Riga Free Port). By qualifying for few criteria it is possible to have corporate income tax allowance in the amount of 80% from the calculated corporate income tax and also other tax relief.

3. Accelerated Depreciation of Fixed Assets Used in Business Activity

In Latvia corporate income tax is calculated by accrual method, wherewith deprecation costs of the fixed assets used in business activity of the company are written off gradually while the income connected with this asset is gained. At the first years of the use of fixed assets it is allowed for taxation purposes to write off higher depreciation costs than in the following years. Such depreciation is a deviation from economic reality and therefore may be regarded as tax incentive. According to calculations made such depreciation decreases taxable income for 20,7% from theoretical taxable income.

4. Special Depreciation for Fixed Assets Acquiring New Production Technological Equipment.

In 2005 additionally to the above-mentioned favourable deprecation system there was created a special depreciation for new production technological equipment in accordance with which the value of the new production technological equipment is multiplied by increased rate. This depreciation system will be in force till 2010.

Discussed Possible Future Tax Incentives

As it was said above there are discussions about new tax incentives which could replace some of the existing ones or supplement the existing ones.

Non-taxation of Reinvested Profit

Non-taxation of reinvested profit is considered as one of possible new tax incentives thus facilitating companies to invest free funds of the company into the business. However, the working group has indicated also several imperfections of such incentive.

Firstly, it has been examined that there has not been seen direct correlation of the increase of investments with the existing tax incentives. Wherewith, it shall be considered very carefully whether any new tax incentive will give that effect what is expected.

Secondly, in Latvia like in many other European states the calculation of the corporate income tax is done by the accrual basis but by introducing non-taxation of reinvested profits there will appear a mixture of accrual and cash methods which will make the calculation of taxable base more comprehensive.

Thirdly, it is not possible to make proper calculations about the influence of such tax incentive on the budget revenues.

Fourthly, if there will be introduced unlimited non-taxation of reinvested profit in order to secure the budget revenues it will be necessary to amend the existing favourable depreciation methods for taxation purposes.

Non-taxation of Undivided Profit

Non-taxation of undivided profit is so called Estonian model. Such new tax incentive will mean the change of corporate income tax system – i.e. transition from the accrual method to the cash method, refusal from depreciation for taxation purposes and very strict control over expenses not connected with business activity. Moreover, by introducing such tax incentive there may appear difficulties with a compliance of some EU directive requirements. At the same time by using EU directive requirements there may increase possibilities for companies to engage in tax planning and avoid taxation, by making different cross-border reorganisations.

Special Incentive for Increase of Equity

The International Monetary Fund has recommended to Latvia to introduce incentive for an increase of equity without profit distribution of that accounting year. In this case the taxable income will be reduced for the amount which is equal to the interest payments which a company would pay to a bank in case it would be obliged to borrow money for an increase of the equity from a bank. Thereby the company by investing its profit into the company (by increase of equity) and without making profit distribution will have a possibility to reduce its taxable income by theoretically possible part of reinvested profit.

The working group has considered this tax incentive as one of the most appropriate ones for Latvia. By introducing this tax incentive it would be possible to keep low taxation burden and simple tax administration. It is also assumed that such tax incentive will have lesser negative influence to the budget revenues.

Conclusion

It is not known yet when and whether the government will implement any of the above-mentioned tax incentives. However, it is announced that government is seriously considering of making some reforms in taxation policy.

Taxation benefits in Estonia with regard to legal changes in 2009

Estonia has a favorable tax system providing low flat tax rates.

Personal income tax:

- 21% during 2008
- 20% during 2009
- 19% during 2010
- Beginning from 2011 18%

Corporate income tax:

- 26,58% (21/0,79) during 2008
- 25% (20/0,80) during 2009
- 23,46% (19/0,81) during 2010
- Beginning from 2011 21,95% (18/0,82)

Yet please observe that is definitely important to mention the problematic adoption of the annual budget and political debates around ceasing the scheduled reduction.

1. **Corporate profits** are subject to taxation only upon their distribution. Undistributed profits are thus a tax exempt and can be reinvested or simply retained within the company.

2. In the case of:

- reduction in the share capital
- liquidation proceeds
- share buybacks

the personal income tax is charged on the amount exceeding the acquisition cost paid to a natural person (both resident and a non-resident) by a resident legal person.

Yet as of 1st January 2009 the **new system will be introduced** purusant to which such payments exceeding contribution to equity **shall be subject to higher corporate income tax**. Relevant shareholders' double tax relief will be provided

3. Furthermore from the 1st of January 2009 Estonian resident companies will **benefit from** an automatic **participation exemption** regarding dividends received from EU Member States, Switzerland, Iceland and Norway. The requirements of **minimum holding period or shareholding percentage (currently 15%)** will cease to apply and thus any **withholding tax** on dividends (as well as royalties) **will be abolished**.

4. **License fees** paid to a non-resident by the resident company will obtain a definite **tax-free character** as conditions set out in Income Tax Act with regard to such payments will be abolished.

5. It might be of importance to notice that with the introduction of changes the **tax period will be extended** to a financial year (currently a month). Advance payments will be supplemented.

6. Finally a negative change to observe is a gesture to ensure equal treatment of resident companies and permanent establishments of non-residents. It will no longer be possible to reduce profits attributed to the permanent establishment by the cost of property brought to Estonia for the PE.

Tallinn Office Opening

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