

# Enterprise Income Tax Reform



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*The new tax reform effective as of 01.01.2018 will have a significant impact on both Latvian and foreign companies. This time, given the volume of changes, it is not possible to give very detail guidelines. However, the minimum changes the shareholders should be informed of regarding the new Corporate Income Tax (CIT) law are summarized below.*

- **Reinvested profit vs distributed profit.** The company's profit earned starting from January 1, 2018 will not be taxed. In this way, a 0% tax will apply, but only as long as the company will retain its profit (also conditional or hidden) as undistributed or will reinvest it into the business.
- **CIT base.** The CIT base will no longer be based on the company's profit and loss statement, but rather on company's cash flow. The taxable base will not only consist of the dividends, but also of the conditional (hidden) distribution of profit, such as loans to related parties, interest expense exceeding thin capitalization limits, transfer pricing adjustments, provisions for debtors > 3 years, expenses for non-economic activities and other statutory payments.

The new formula<sup>1</sup> for CIT base is:

$$\text{Dividends (net) and} \\ \text{Conditional (hidden) profit distribution} / 0.8 * 20\%$$

- **Loans.** In order to prevent any hidden distribution of profit (expected due to the new CIT rules), loans to related parties henceforward will be included in the CIT base. Nevertheless, a number of exceptions have been introduced, such as loans to subsidiaries, short-term loans up to 12 months, loans issued by a company that does not have any undistributed profits appearing in the opening balance sheet and loans that do not exceed the retained earnings as at 31 December 2017.
- **Thin capitalization/ Interest expense.** In principle, there will be only one thin capitalization formula left for companies, and namely - the principal amount of the non-bank loan to equity (and the related interest expense that the company will write off) shall not exceed the  $\frac{1}{4}$  proportion. The second criteria about the market rate of the interest will be replaced by the transfer pricing rules and will only remain [slightly modified] to the non-bank interest payments above 3 million EUR.
- **Transfer pricing (TP) adjustment.** Related-party transactions will even more strictly adhere to the market price policies. The volume of transactions and turnover subject to the TP documentation will remain the same (turnover of >1.43 million EUR and transaction over 14 300 EUR), but the amount of participation will be decreased from 90% to 20% to qualify as related parties. In the event of a non-compliance, the CIT tax base will have to be increased once a year. In fact, the only argument for not making tax adjustments upon carrying out related-party deals will be a well-designed transfer pricing policy.
- **Provisions and debtors.** The debtors for whom the accruals were made or have been written-off must be recovered in a three years period in order not to form the CIT base under the new tax rules. Otherwise, unless your debt qualifies for statutory exemption, CIT base shall be increased for the amount of unrecovered debt.
- **Expenses not related to economic activity.** These are all kind of indirect business expenses, such as leisure activities and recreational events for employees or management (also fringe benefits allocated to the management by a non-resident), representation and expenses on personnel sustainability events exceeding 5% of the company's total salary fund, as well as other deduction of profit or turnover according to initiative of tax payer, disproportionate penalty payments, over limit fuel and excess natural resource tax, expenses on representative vehicle etc. The coefficient 0.8 will be applied and 20% tax will be calculated for all the expenses mentioned, resulting in the effective tax rate of 25% (unless such expenses could be personified, in which case they will be subject to the payroll taxes).

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<sup>1</sup> This formula provides that the effective tax rate is 25% if calculated from the amount of the net taxable object. In turn, if the rate is applied to the gross amount (as in the case of dividends), the tax rate is 20%. Dividends paid in Latvia or abroad will not be included in the CIT base (tax exemption).

- **Representation and personnel sustainability expenses.** These expenses in future will either qualify as fully tax deductible - business related (if accounted separately) or will become subject to even greater restriction with the upper limit of 5% from the company's total salary fund (instead of 40/60%, which will remain applicable for VAT purposes). Any excess amount will be subject to 25% [effective] tax rate. This restriction will apply to expenses on restaurants, meals and other recreational events, welfare expenses for employees and managers, socializing events and similar expenses, the total aggregate of which is restricted to 5% of the company's salary fund, subject to mandatory social insurance contributions.
- **Non-resident taxes.** 20% CIT shall be deducted when making payment to a non-resident for management and consultative services, if the residence certificate has not been received. Remuneration received from disposal of real estate will be subject to 3% tax rate, which the non-resident can recalculate at the year-end, claiming tax deduction for the purchase costs and applying 20% withholding tax to net profit. The same tax has to be imposed on dividends and payments to offshores (currently there are still 26 countries in the offshore list).
- **Permanent establishments.** Permanent establishments registered in Latvia will calculate the CIT once per year by submitting a declaration of December month. The determination of the permanent establishment's CIT base will be regulated by the Cabinet regulations, the new version of which is expected. In any case, fringe benefits granted to the management and employees, or other costs reallocated to the PE by its parent- or other related companies (not just the profit share) shall be analysed more carefully for CIT purposes.
- **Dividends.** Dividends in respect of which the tax has already once been paid domestically or abroad will be exempted from the 20% CIT. The same applies to capitalized profit, but only until the shareholders will decide to reduce the company's share capital. In turn, the liquidation quota will be regarded as a conditional distribution of profit and will form the CIT base.
- **Tax losses.** Starting from 1 January 2018 tax losses (the same as tax depreciation of fixed assets) will no longer be calculated. For the tax losses accrued by 31 December, 2017, there is a transitional period of five (5) years during which at the time of dividend distribution a company will be able to use 15% of the accrued (until 31.12.2017) and not yet utilized losses, however, not exceeding ½ of the calculated CIT of the company's tax year.
- **CIT declarations.** CIT declaration will have to be submitted to the tax authorities for each tax month in which the company has performed a CIT taxable transaction (dividends and other expenses not related to economic activity). Monthly declarations will have to be submitted by the 20th day following the tax month, but for the taxation period from 1 January to 30 June 2018, the company will be allowed to submit a single declaration by paying the tax until 20 July 2018. Costs that are subject to an analytical review to determine their inclusion or non-inclusion in the CIT base (for example, loans issued, provisions for debtors, representation and staff sustainability costs) will have to be evaluated at the end of the reporting year and included in the declaration for the last month.

They for whom the reporting year does not coincide with the calendar year, must submit an interim report by 30 April 2018 with the CIT declaration (according to the old law) for the period from the beginning of the reporting year to 31 December 2017 as well as from 1 January 2018 January to the end of the reporting year (according to the new law).

- **Advance payments.** Starting from July 1, 2018, CIT advance payments will be abolished. However, advances paid in the first half of the year (every month in the amount of 1/12 of CIT for 2016, as the result for year 2017 will not yet be known by January 1, 2018) will be refunded from the budget only after the end of the tax year, namely, starting from 2019, once the CIT declaration for year 2018 will be submitted.

### What should be done by the end of 2017?

- In spite of a transitional period of two (2) years, in general, it is advisable to distribute the accrued profit in dividends to the shareholders until the end of 2017. In doing so during the transitional period, it is necessary to assess other financial items and the linkage with the increased interest element (potentially reflecting on insolvency and capital adequacy) as well as loans to related parties, for example, if a long-term loan to a related party was issued that exceeds the company's retained earnings until 31 December 2017. After 31 December 2019, a 10% tax on dividends on profits earned before 31 December 2017 will be replaced by a capital income tax of 20%.
- For the representative vehicle (with residual value less than 50 000 EUR without VAT) sales-back transaction with a leasing company could be considered to minimize the company's tax burden in future.
- From the next year (if the criterion set by the law are not met) bad debtors will form the CIT base, therefore it is desirable to write off such debtors by the end of 2017. Otherwise, it may be necessary to pay 25% after 36 months from the date of creation of stocks, at the time of writing off at profit or loss calculation or through the provisions.
- It is recommended to maximize the use of accrued tax losses by the end of the year. Starting from 2018 tax losses will no longer be used except for "old losses" over a transitional period of five (5) years with statutory limitations. The introduction of the new anti-evasion measures effective as of 1 January 2018 along with the principles of recognition of revenue and expenditure established by IFRS and the Law on Annual Reports shall be considered upon planning of commercial transactions and profits until the end of 2017.
- If it is planned to dispose of equity shares in the near future, it would be important to assess the holding time of such shares. This should be done due to the changes in tax regime restricting the holding of participation shares for at least 3 years (or 36 months) before they are sold at a 0% rate.
- The financing structures within the group should be revised by the end of the year in order to avoid formation of CIT base for loans, non-bank interest payments or transfer prices as of January 1, 2018

If you have any specific questions regarding application of the new CIT to your company, please contact us by phone +371 67321000 or by e-mail addressed to Ina Spridzāne, Head of the Tax Services of Baker Tilly Baltics SIA, email: [ina@bakertillybaltics.lv](mailto:ina@bakertillybaltics.lv) or her deputy Anna Vilka, email: [anna@bakertillybaltics.lv](mailto:anna@bakertillybaltics.lv), but questions regarding group financing structure and transfer prices (incl. documentation) - financial consultant Reinis Ceplis, email: [reinis@bakertillybaltics.lv](mailto:reinis@bakertillybaltics.lv)