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The Foreign Investors Council In Latvia Position On Tax and Tax Administration

1. Executive Summary

In Latvia, tax matters are often discussed without paying due regard to both the systemic role of individual taxes and a broader social context of the tax system. Changes in taxation are usually regarded as tools for raising more revenue. In the context of the current fiscal situation the revenue issue cannot be dismissed – indeed, there are tax measures that are preferable to many expenditure side measures available to close the deficit. However, FICIL would like to pay attention to possible synergies between improvements in the tax burden structure, governance, and a constructive dialogue between government and society. Gains are clearly available as tax evasion, poor quality of some public services, and low opinion regarding public administration are interlinked.

2. Recommendations/ Suggestions

To counter tax evasion, improve the quality of public services and gain broad public support to structural reforms, FICIL believes that “Time for Change” approach is a solution, comprising the following:

- (i) Economic incentives: shift tax burden from personal income to residential real estate, introduce zero declarations, support job creation by via tax reductions and/ or subsidies
- (ii) Strict law enforcement and tax administration: severer penalties to tax evaders, adequate use of available databases, positive motivation to honest taxpayers;
- (iii) Increasing transparency of public spending: make available cost analysis of public spending on subsidies, increase taxpayers’ participation in expenditure decisions
- (iv) Stability and good communication: trust and a clear medium-to-long term vision is crucial to have popular support to the government’s strategy.

This approach provides clear benefits to honest tax payers to remain such and credible punishment for those evading taxes thereby providing motivation to shift out of grey economy. It is crucial to use carrot and stick simultaneously rather than introducing punishment now and delaying positive motivation to uncertain and distant future.

Appendix to the position list more detailed Tax considerations developed by The Foreign Investors Council In Latvia Tax group considerations

3. Rationale

The share of grey economy has grown, which is clearly seen e.g. in the share of tax revenues to GDP that has fallen from nearly 30% in the early 2009 to just 25.5% by the end of the year. With fairly similar changes in the tax system the share of tax revenues to GDP has remained about flat in Lithuania and grown in Estonia. Widening and deepening of grey economy is not acceptable – it will cripple Latvia’s internal competition and external competitiveness, hamper recovery, and implant problems of social and economic nature that will take huge future cost to deal with. There is widespread perception that recent tax rises have contributed to increase of tax evasion and therefore the government should be extremely cautious in attempts to increase tax burden further.

FICIL believes that the size of the overall tax burden is about right but there are necessary shifts in the distribution of the current tax base/ burden.

To break the cycle of unwillingness to pay taxes FICIL suggests “Time for Change” approach that addresses the interlocking problems simultaneously. Below are described several measures most of which have already been publicly discussed separately while their combined effects have been overlooked.

Economic incentives

There is a strong case for shifting the tax burden on individuals from personal income taxes to residential real estate. This would help by reducing labour costs to companies and thus improving their competitiveness, and shifting the tax base where tax evasion is more difficult. These changes should be designed in a way that improve the financial situation of low income earners and put more burden on those evading taxes. FICIL suggests to implement the following changes:

- Reduce personal income tax rate (target: to ca 20% from the current 26%) and increase non-taxable minimum (target: 2 times to 70 LVL), such reductions in personal income tax burden must be significantly large to provide visible benefits to tax payers;
- Raise residential real estate tax (target: to ca 2.5% of cadastral value) to make the above personal income tax changes fiscally neutral for the budget;
- Reset the social tax contribution annual cap to the 2006 level (20.700 LVL) and link the level of social security benefits to the level of contributions made;
- Strengthen the control of taxes paid by private individuals through implementing the so called zero declarations and corroborating the origin of financial means used for purchasing luxury items.

To support private sector motivation for job creation and reduce the tensions in the society’s most vulnerable social groups, FICIL sees it beneficial to:

- Introduce significant temporary reduction in the social tax contributions to companies when they hire long term unemployed and/ or youngsters for their first job. This measure should have a positive fiscal effect on the budget.
- Introduce tax reliefs for large investment projects, e.g. by re-establishing the corporate tax relief for large investment projects available until 2004, for creating new jobs, for developing infrastructure.

Recently Lithuania attracted an investment from Barclay’s bank that set up back office operations centre, employing several hundred people. The crucial factor in this decision was up-front payment from the government covering wages for the first six months of operations that has already been recovered via taxes. FICIL supports the introduction of similar measures in Latvia as providing employment subsidies is preferable to paying unemployment benefits; these can take the form of tax deductions or direct payments and should apply to any (local/ foreign) investors.

Strict law enforcement & Tax administration

We see it crucial to use instruments of positive motivation to tax payers, i.e. “carrot”, rather than solely relying on a “stick”. The culture of tax evasion is firmly established in Latvia and it needs to be rooted out. Improved tax administration not only provides tax revenues, but also removes distortions and unfair competition created by tax evasion. While there have been significant improvements on the part of the tax authorities, further effort must be directed to identifying and combating tax evaders rather than using the resources over and over again on auditing honest taxpayers. The tax authorities must become more forthcoming regarding those who cooperate. With respect to entrenched tax evasion FICIL suggests to:

- Introduce severer penalties for the employers evading payroll taxes, penalties on recipients of untaxed salaries – fines, public works, jail terms for worst offenders;
- Introduce severer penalties to businesses that underreport sales.

Increasing transparency of public spending

To strengthen support to the “Time for Change” strategy, it is necessary to show clearly that the tax revenues are spent in line with the value-for-money principle. Therefore FICIL sees it necessary to further increase the transparency of public spending:

- Making available a detailed analysis of public spending of subsidies, e.g. regarding transport, farming support, beneficiaries of such support;
- Wider introduction of voucher system for paying for public services, e.g. vouchers with indicated cash value for covering the cost of secondary education, possibly also part of higher education in public and private sector; in general making benefits from taxes more obvious, personal and tangible.

Stability and better communication

FICIL believes that certainty and timing of any changes are important. Therefore we see it necessary for the government to issue a formal statement confirming that either (i) there will be no substantial changes in the tax laws affecting businesses in a significant way for the next five years or, in the contrary, (ii) to announce these measures immediately. The above document clearly shows that we believe that the second option is the one to follow and to do so one should ensure:

- Stability and transparency of the tax system;
- Clearly communicated, consistent long term tax strategy and tax policy;
- Sufficient transition periods for taxpayers;
- Communication and consultation process to determine how changes in tax laws will affect various industries.

A meaningful communication of the suggested “Time for Change” approach is key, the best way of conveying the message to the taxpayers must be sought.

Appendix

More detailed Tax considerations developed by The Foreign Investors Council in Latvia Tax group

Government should aim to have clearly communicated, consistent long-term tax strategy and tax policy to promote stability and predictability of tax system. FICIL suggests that a detailed communication and consultation process is in place to determine how changes in tax laws will affect various industries.

Corporate Income Tax

1. To allow accumulated tax losses to be carried forward and set off against next year profit for an unlimited time period. To allow the current year tax loss to be carried back and set off against prior year profit for a period of up to a maximum of three years. To allow transfer of losses within the group for period of 8 years. Transfer of losses still is one of the reasons why investors are not interested in investing considerable resources in new production facilities, new fixed assets or office space. Such large investments require large resources and 8 year period usually is not sufficient to receive sufficient profits to be able to write off the investment.
2. To allow depreciation of goodwill for tax purposes.
3. Bad debt provisions should be tax deductible for all companies, write-off criteria for tax deduction of bad debts should be updated, simplified and applicable in practice for all companies, including leasing companies. Editorial changes in the Law on Corporate Income Tax regarding deduction of bank loan write-offs should be made to ensure that write-offs are unanimously treated as a tax deductible item.
4. To provide for transfer pricing corresponding adjustment for related parties.
5. To provide for exemption from taxation for capital gains if the share holding period is 5 years or more and the company has been consolidated.
6. To abolish withholding tax on interest payments between related parties and withholding tax on sales proceeds from sale of real estate located in Latvia and sale of shares in companies holding real estate in Latvia.
7. To provide clearer definitions of business activities in relation to non-for-profit organizations.
8. Remove road documentation requirements for administrative transport by making part of expenses as non-deductible).
9. Review of documentary requirements for application/ exemption from withholding tax.

Value Added Tax

1. VAT refund system needs to be clarified in regard to input VAT which is older than 3 years. Currently it is not clear what will happen to such overpaid VAT and how companies will be able to receive this money from state.
2. Introduction of special VAT regime for PPP projects.
3. To implement provisions related to recovery of VAT on bad debts and to provide an option to apply VAT on real estate and financial services.

Social Security Contributions

1. To reinstate ceiling for the maximum amount of social security contributions. The abolition of ceiling for the maximum amount of social security contributions provides short-term positive effect on the revenues of the state social security budget. The long-term effect on the state social security budget will be negative – the expenses for pension, sick benefits, maternity

- and paternity benefits will increase as a result additional budget expenses will arise. The tax burden for the employers increase and Latvia becomes less attractive to the foreign investors.
2. To introduce discounts from social security contribution employer part for large employers either by reduction depending from amount of people employed/ depending from amount of social contributions paid. Such discounts will promote creation of working places and assist in reducing unemployment in the country.
 3. FICIL suggests considering to return to 8% of contribution amounts to be included to the 2nd pension level scheme.

Excise Tax

1. To adjust the gap between excise tax rate for cigarettes, cigars and cigarillos. Currently excise tax on cigars and cigarillos is considerably lower than the tax on cigarettes and this created uneven playing field for companies operating in this industry.
2. Determine a priority of State Revenue Service to ensure all necessary control arrangements that prevents duty unpaid cigarette and alcohol supplies from Russia and Belorussia.
3. To reduce excise tax on alcohol.
4. Review of proposed system for excise tax refund on fuel for farmers.
5. Review of guarantee system for excise goods.

Personal Income Tax

1. To further update the Law on Personal Income Tax and ensure that appropriate clarifications for application of the law are available, i.e. definitions of financial instruments, secondment of personnel.
2. To simplify declaration and payment of tax on capital income and capital gains by allowing tax returns to be prepared once a year instead of monthly/quarterly.
3. To reduce personal income tax rate for employment income.
4. To expand the list of allowable deductions of up to 10% of gross taxable income and include also education expenses and interest paid for real estate loans.

Stamp duty

Review of stamp duty system in Latvia and aligning the amount of stamp duty to services provided.

Tax Administration

1. Tax audit activity should be focused on grey economy and collection of unpaid taxes. This would ensure larger tax income in State Budget and prevent future incentives for tax evasion.
2. Preferred taxpayer status/ Tax certification. We believe that government should co-operate with professionals performing external audits on financial statements of businesses, as they possess a large amount of information on potential tax evaders. Government should consider introducing preferred taxpayer status for companies with long-term record of tax compliance and consider tax certification requirement for companies operating in areas where tax evasion is more prominent to ensure better collection of taxes. Experience of The Netherlands, Greece and Turkey as well as other countries with such norms can be used to create a system, which would work the best in Latvia.
3. Review of companies employing self-employed persons to determine if law has been observed.
4. Possibility for company to apply for advance rulings on behalf of their employees.