FICIL Position Paper No. 4

Foreign Investors' Council in Latvia's Position on Tax Policy and Tax Administration

10 September 2020

Executive Summary

The Foreign Investors' Council in Latvia (hereinafter – FICIL) is closely following the changes in tax policy guidelines, given that this is an important aspect of improving the competitiveness of the business environment. In the *Doing Business 2020* publication, Latvia is in 19th place, the lowest among the Baltic states, and great emphasis is placed on the section *Paying Taxes*, which mentions that Latvia has increased the tax burden. [1]

The Covid-19 crisis has changed the circumstances of the tax reform and has served as a stress test for the tax system of Latvia. On several occasions such tax regimes have been highlighted that leave taxpayers vulnerable in emergency situations. In view of the proposed aid instruments, the question arises as to how the national tax base will be replenished when the state budget revenues decrease? Will this happen by fighting the shadow economy more effectively, or by raising tax rates? The key question remains: what are we trying to achieve with the tax policy reform?

The issue of the predictability and stability of the tax system has long been a pressing matter. Businesses plan their operation in specific countries for several years ahead, so it is important to ensure confidence and stability regarding the development, rates and administration of the tax policy..

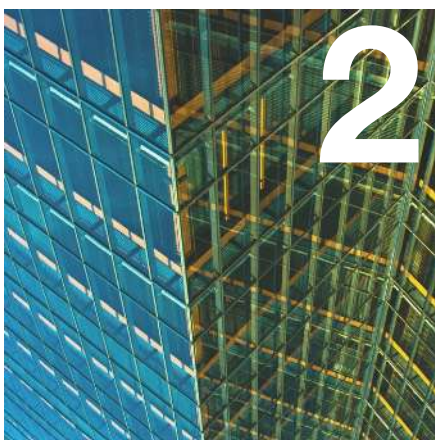
It is necessary to renew an in-depth discussion on how to adjust the Latvian tax system to global trends. FICIL has commented on direct and indirect taxes, apart from the review of the state social insurance reform, as FICIL believes that this issue should be assessed along with the entire welfare and health care system. One issue is the plan, but the reality is something entirely different. FICIL provides an objective assessment of the current situation, but a more detailed analysis of the positive and negative aspects of the tax system is needed.

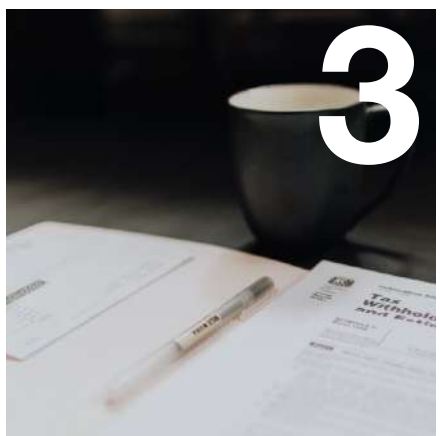
FICIL highlights the importance of a predictable, stable, simple and competitive tax policy in any country. In order to facilitate the further development of the tax system, it is essential to identify in detail the advantages and disadvantages of the existing tax system. In our opinion, a professional assessment of the order *On the National Tax Policy Guidelines for 2018-2021* is necessary, focusing on the achievement of the objectives of the previous reform and the analysis of actions.

Another important aspect of tax policy is the reduction of the shadow economy sector. The study *Shadow Economic Index for the Baltic Countries* shows that in Latvia the level of the shadow economy is 23.9 % of the GDP. [2] The shadow economy can take many forms, from envelope wages to not declaring the number of employees. Currently, the fight against the shadow economy is only a responsibility of the SRS, but without the joint action of various institutions, this is often not enough. The responsible national authorities must actively address this problem, with a concrete action plan and close cooperation within the public sector. Taxes must be relatively simple to administer, motivating more people to leave the grey sector. Taxation and tax benefits must be carefully assessed and balanced in order to promote ethical behaviour rather than avoidance.

Content

In order to promote the development of a competitive business environment in Latvia and to increase Latvia's international attractiveness with a predictable long-term tax policy, as well as to achieve growth rates that will ensure that the economy of Latvia aligns with the economic processes of OECD countries, FICIL also provides detailed proposals for improving the macroeconomic and tax policies in Latvia. In preparation for the 2021 tax reform, FICIL offers proposals in four sections:



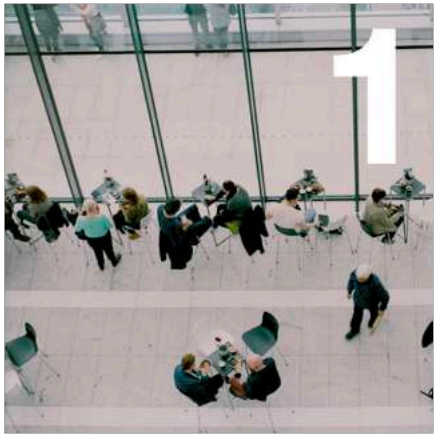


References

1 http://documents1.worldbank.org/curated/en/688761571934946384/pdf/Doing-Business-2020-Comparing-Business-Regulation-in-190-Economies.pdf

2 https://www.sseriga.edu/shadow-economy-index-baltic-countries

Recommendations by sections



Personal income tax, mandatory state social insurance contributions, solidarity tax, and microenterprise tax

Group 1	Issue	Solution
	PRIORITY A	
1	**IIN un VSAOI.** Different small service providers operate in the grey sector; personal income tax and mandatory state social insurance contributions are not payed, including such cases as working in addition to the main job, carrying out temporary occasional work. For example, there are IT specialists, as well as consultants who are in paid employment, whose employment contract does not stipulate that they cannot work elsewhere concurrently, thus they provide small-scale services to earn additional income. Payroll taxes are potentially not paid on income that a person receives outside the main job because it is difficult to calculate and declare this income.	To establish a single regime for all short-term small service providers who carry out work done by themselves. To extend the existing simplified tax payment regime to involve such taxpayers as nannies, hairdressers, photographers, cleaners, designers, etc. The remuneration shall be subject to a low rate without deducting the expenditure of economic activities. Customers shall pay this remuneration to a bank account, the total amount of remuneration subject to such regime may not exceed the VAT threshold per year (40,000 per year).

2	**Personal income tax and mandatory state social insurance contributions.** The application of the differentiated non-taxable minimum (DNM) is complex and does not achieve the objective of supporting small-wage recipients and families with children (e.g. it is not possible to use the tax benefits provided for by law). Existing wage tax framework: 1) subsidises the economy of cheap labour and hinders progress towards a higher-value-added and higher-wage economy; 2) distorts competition between payers of envelope wages and companies that, while working in the same market, pay remuneration together with wage taxes in full.	To review the amount of the non-taxable minimum and its application. It is necessary to set a fixed non-taxable minimum or to simplify the calculation of wages by cancelling DNM and introducing several levels of progressivity.
3	**Personal income tax and mandatory state social insurance contributions.** The existing system for calculating labour taxes is difficult for many taxpayers to understand. Overly fragmented eligible expenditure rules, which are difficult to apply and understand. The various eligible expenditure categories and limits do not create equal opportunities for all taxpayers.	To simplify the calculation system for personal income tax, social contributions and solidarity tax. The solidarity tax should be combined with the personal income tax. To set a fixed non-taxable minimum depending on the amount of annual income. To make the application of eligible expenditure simpler by setting the same limit for all expenditure each year, e.g. 10-20% of the annual gross taxable income per person for all categories of expenditure.

4	**Personal income tax.** If a non-resident of Latvia sells real estate to a Latvian company, the company withholds personal income tax in the amount of 3% of the transaction value and it is not possible for a non-resident to avoid paying taxes because the tax must be withheld at the moment of payment of the income. At the same time, if a non-resident is a resident of a country with which Latvia has entered into a convention, in certain cases a non-resident may recover the tax paid by submitting a certified resident certificate to the SRS. However, if a non-resident derives income from the alienation of real estate or other capital assets from a natural person who is not a performer of economic activity, the non-resident must calculate the tax on that income and submit a declaration of income from capital to the SRS. There is a very high risk that the tax will not be paid, as there is no control mechanism allowing the SRS to ensure compliance with the obligation to pay the tax.	Provisions should be made for a control mechanism for transactions between non-residents and natural persons (residents of Latvia) to reduce tax evasion. Within the framework of the control mechanism, checks on the payment of tax by a notary or in the land register may be introduced without imposing on a notary or land register the obligation to carry out actual withholding or payment of tax, but establishing the obtaining of proof of actual tax payment from the SRS as a precondition for the approval of registration.
5	**Personal income tax.** Inconsistencies in the Enterprise Income Tax Law and law On Personal Income Tax if a non-resident alienates real estate from another non-resident.	To align the legal provisions of the law On Personal Income Tax with the Enterprise Income Tax Law in the event of the alienation of real estate between two non-residents. Namely, the seller may choose to apply a 20% personal income tax on the profits by submitting an annual statement of income instead of applying a 3% tax on the transaction value.
6	**Personal income tax and mandatory state social insurance contributions.** *On Personal Income Tax: Section 9*	To review the amount of the tax-free gift from the employer per year for an employee. To waive the limit

	The current amount of a gift from the employer is not consistent with Latvia's economic situation. The tax-free gift from the employer in the amount of EUR 15 is inappropriately small and should be increased.	of the tax-free gift from the employer, making it part of sustainable activities of personnel.
7	**Personal income tax.** *On Personal Income Tax: Section 8* Clause 18.[3] 4 of the Procedure regarding the Application of Norms of the law On Personal Income Tax It is not clear what "employee benefits" are and the tax on benefits is difficult to calculate. At present, employee discounts are equivalent to benefits and are subject to personal income tax and social tax, but companies grant discounts to allow employees to get to know their products, be knowledgeable and share their positive experiences. The discount granted is not a benefit equivalent to wages. The share of taxable benefits is very complex to calculate, and it is often impossible to attribute it to a particular employee.	To review the definition of benefits, taking into account the market situation and employers' benefits baskets. To consider possibilities to create a simpler way of accounting/calculating taxes. Regulations of the Cabinet of Ministers are required that specify what is considered a benefit and what is not considered as such.
8	**Personal income tax.** Balancing the tax burden of foreign investors.	To determine that 10% of the taxes payable in Latvia in the case of distribution of profits is the deductible personal income tax, so that foreign tax residents can include it as their local personal income tax.
9	**Personal income tax.** When renting or leasing immovable property to a natural person, the law On Personal Income Tax provides for the possibility of not registering the economic activity with the SRS and applying a 10% personal income tax rate, without deducting expenses.	To specify the personal income tax rules that apply when the immovable property to be rented or leased is located either in Latvia, or abroad, as well as clearly indicating the possible regime for the application of the personal income tax.

	If the property is located abroad, the practice of the SRS shows that the income is to be declared in Annex D2 of the annual statement of income and is subject to the progressive personal income tax rate. In practice, it is impossible to apply a 10% rate and discrimination arises on the grounds of the location of property, which should not be the case within the EU and the Convention countries.	
(9) Comment	Following negotiations with the Ministry of Finance, for efficiency reasons item 9 has now been removed from the agenda.	
10	**Personal income tax.** In accordance with Section 11, Paragraph 3.2 of the law On Personal Income Tax, the types of expenditure of economic activities, which are to be included in full, are, among others, "Salary and State social insurance mandatory contributions of the employer, including solidarity tax which a performer of economic activity pays for his or her employees." In accordance with Regulation of the Cabinet of Ministers No 662 of 30 October 2018, state social insurance mandatory contributions paid by a natural person as a self-employed person are also included in the expenditure.	To supplement Section 11, Paragraph 3.2, Clause 1 of the law On Personal Income Tax: 1) salary and State social insurance mandatory contributions of the employer (including contributions paid by self-employed persons), including solidarity tax which a performer of economic activity pays for his or her employees.
11	**EDS functionality (Personal income tax).** The company's accountant is not able to verify the residence status of employees (aliens) in Latvia. Nor is it possible to obtain information about specific periods of residence status and countries of residence.	To introduce an EDS section, where information on the residence status of employees (aliens), residence periods and countries of residence is available.
12	**EDS functionality (Personal income tax).** The EDS system automatically generates an overpayment of personal	To specify automatic settings for annual statements of income.

	income tax in the annual statement of income of a natural person (which is formed by the distribution of solidarity tax by the SSIA), in cases where the income from paid employment is not taxable in Latvia. The taxable person (natural person) does not have the possibility to create a correct annual statement of income.	
13	**EDS functionality (Personal income tax).** If the company has several hundred employees, the accountant has limited ability to filter the required salary tax booklet data (for example, to understand which employee is subject to the progressive personal income tax rate and who is subject to the 23% personal income tax rate).	To introduce a *sort* function in the EDS section *Salary Tax Booklet*, making it possible to quickly and easily check which employee is subject to the progressive rate and for whom only a 23% personal income tax rate applies. To create a possibility to download salary tax booklet data into an *Excel* file.
14	**EDS functionality (Personal income tax).** A natural person may include, by submitting his annual statement of income, eligible expenditure on medical and educational expenses both for himself and for family members. If a person also includes expenditure of a member of the family, the family member concerned will not find out about it. When that family member submits his or her annual statement of income, the SRS will state that it has been drawn up in an incorrect way and that part of the amount of expenditure to be included has already been used.	To introduce a warning on the use of the amount to be included in the eligible expenditure.

Recommendations by sections

Enterprise income tax, immovable property tax, vehicle operation tax, and company car tax

Group 2	Issue	Solution
	PRIORITY A	
1	**Enterprise income tax.** Transfer prices and adjustment for increased interest. The Enterprise Income Tax Law states that the taxable base includes a transfer price adjustment and an adjustment for increased interest payments. The previous Enterprise Income Tax Law (which was in force until 31 December 2017) stipulated that, if the company had to make both adjustments, the taxable income would have to be increased by only one of the adjustments – the highest. The new Enterprise Income Tax Law does not provide for such a provision, which may result in double taxation of the same amount of interest expenditure.	To provide that, in the event of an increasing adjustment for a taxable person from both failing to follow market prices and increased interest expenditure, the taxable person is required to make an enterprise income tax payment from the largest of these positions.
2	**Enterprise income tax.** Double taxation in the case of transfer price adjustments between two companies.	To allow the company to make a corresponding adjustment if the other party has paid the tax on the

		transfer price adjustment.
3	**Enterprise income tax and transfer price adjustment.** Taking into account Paragraph 9, Section 4 of the Enterprise Income Tax Law, the taxpayer determines the base taxable with the enterprise income tax by dividing the value of the object by a coefficient of 0.8 for gross basis. This framework also applies to the difference where transactions between related companies have not been carried out on the basis of a market principle that would apply between independent persons. This difference is essentially already a gross basis (foregone earnings before tax). Thus, by redividing it by a coefficient of 0.8, an artificial increase in the taxable base is created.	To review situations to determine if a coefficient of 0.8 is necessary.
4	**Enterprise income tax.** According to the SRS, permanent establishments of foreign companies in Latvia are not entitled to reduce the base taxable with the enterprise income tax for the expenditure of economic activities related to services, interest payments on loans, etc., received from a non-resident whose permanent establishment it is. They have an additional tax burden of 0.2/0.8. This is contrary to (i) the agreements of the government of the Republic of Latvia on the promotion and mutual protection of investments, (ii) the Treaty Establishing the European Community, (iii) the EU case-law and (iv) the OECD authorised access to the attributing income and costs	To supplement the enterprise income tax norms by stating that, in order to determine the taxable income of the permanent establishment, it is necessary to separate the branch from the rest of the company as a hypothetical independent company, which will be an associated person with the rest of the company and will apply the principles of transfer prices in accordance with the methods and tools proposed by the OECD guidelines. It is necessary to introduce a framework for permanent establishments which prevents the discrimination of non-residents in the determination of expenditure of economic activities compared to businesses acting here as separate legal entities.

	to the permanent establishment (branch), and makes the branch an unattractive form of business in Latvia.	
5	**Enterprise income tax: transfer prices.** According to its interpretation of Section 15.^{2} of the Law on Taxes and Duties, in relation to controlled loan and/or borrowing transactions, the SRS also considers the principal amount of the loan/borrowing as the amount of the controlled transactions. This is contrary to accounting logic. Moreover, the annotation of the law provided that only around 200 companies would have to automatically submit transfer price records, as opposed to more than 2000 companies according with the above-mentioned interpretation of the SRS. In other countries, there is no such administrative burden and associated costs, and this certainly has a negative impact on investment decisions.	To supplement the Regulation of the Cabinet of Ministers No 677, Section 15.^{2} of the Law on Taxes and Duties or the Regulation of the Cabinet of Ministers No 802, stating that only transaction values that have an impact on the taxpayer's profit or loss account are considered as the amount of controlled transactions. In the case of loan/borrowing transactions, this would be only the amount of calculated (paid) interest.
6	**Enterprise income tax.** Latvian groups of companies that prepare the consolidated annual report cannot divide representation expenses within the group of companies. The restriction also applies where a company in a group performs an administrative function in providing services to other companies in the group and consequently the provider of services has the highest number of employees. *Enterprise Income Tax Law: Section 8* The explanation of sustainable activities of personnel is too narrow and does not include sustainable activities of personnel at different levels of the organisation, specific to	To grant a tax benefit to a group of companies that submits a consolidated annual report to the tax administration, allowing the group to choose annually one of the companies for which the total 5% tax benefit of representation expenses is applied, attributing it to all the group employees that are located in Latvia, i.e. the total representation expenses and costs of sustainable activities of personnel can be calculated as 5% of the total salary fund of group employees in Latvia – this must be stated separately in the annual report.

	large companies, where personnel events are not always organised for all levels of staff and regional groups at the same time due to the specific nature of the work of the organisation.	Options: – Use total number of company employees – A separate service
6A	**Enterprise income tax and personal income tax.** Promoting the mobility of workers (service hotels/transport) in cases where it is necessary to attract workers from other cities/regions.	Not subject to payroll tax and enterprise income tax: (a) payments by the employer to cover the rent of an employee if the employee's habitual residence is in another city or region; (b) transport costs for access to work and home in a region or other town covered by the employer, using his or her own resources.
7	**Enterprise income tax and permanent establishments.** There are currently uncertainties as to the application of Paragraph 22-24 of the Regulation of the Cabinet of Ministers No 677 (Rules for Applying the Norms of the Enterprise Income Tax Law). There is no clear framework on the corroborative documents, which are sufficient to justify the expenditure of the permanent establishment (only external or internal corroborative documents as well). The practical application of the 10% set out in Paragraph 24 of the Regulation of the Cabinet of Ministers No 677 is also not clear. For this reason, taxpayers have different interpretations and understanding.	To provide further clarifications on the application of the enterprise income tax for permanent establishments, ensuring a systemic approach and non-discrimination, compared to companies registered in Latvia (violation of the EU Treaty).
8	**Enterprise income tax and permanent establishments.** The Enterprise Income Tax Law does not provide sufficient explanation on how the application of double enterprise income tax is avoided in a situation where Latvia has a	To make amendments to the Enterprise Income Tax Law.

	principal company with permanent establishments outside Latvia and these permanent establishments incur expenses not related to economic activity that are taxed with enterprise income tax in the country concerned. Taking into account the current regulation of the Enterprise Income Tax Law on the respective expenses not related to economic activity, the enterprise income tax will be paid twice: in the jurisdiction where the permanent establishment is located, and in Latvia.	
9	**Enterprise income tax and reorganisation.** In the event of a reorganisation where one company of the group is added to another, the taxpayer is not entitled to reduce the amount of dividends included in the taxable base to that extent if during the taxation period the connected company has benefited from the disposal of direct holding shares with a holding period of less than 36 months. As a result of the reorganisation, this holding period does not continue, but resumes from zero.	If the reorganisation takes place within a group, for example, two subsidiaries are merged, it would be reasonable to count the 36 months in a compound order. In the event of a reorganisation, it is necessary to ensure that there is a complete transition of all rights and obligations.
10	**Enterprise income tax and reorganisation.** The Enterprise Income Tax Law does not provide for the application of the enterprise income tax in the case of cross-border reorganisation. For example, a sister company in Estonia or Lithuania is added to a Latvian company. In this situation, it is essential to provide for the application of the enterprise income tax to the distribution of profits earned by the Estonian/Lithuanian company before joining the Latvian company and for which the enterprise income tax has been	To develop amendments to the Enterprise Income Tax Law, it is necessary to clarify the regulation.

	paid in that country in order to avoid double taxation. As regards cross-border reorganisations, no provisions have been made for the consequences of the enterprise income tax in a situation where a Latvian company joins a company outside Latvia and no permanent establishment is maintained in Latvia that would take over the assets and liabilities of the Latvian company being added.	
11	**Enterprise income tax and reorganisation.** The above issue is also relevant in a situation where the company has a share of foreign companies (e.g. share capital or retained profits) added to it before liquidation in case of cross-border merger. According to Paragraph 4, Section 7 of the Enterprise Income Tax Law, the liquidation quota is also to be regarded as conditional dividends. It is therefore necessary to clarify whether, in such a case, it is possible to pay out dividends or to receive a free-of-tax liquidation quota, since the tax has already been paid on those positions abroad.	To develop amendments to the Enterprise Income Tax Law, it is necessary to clarify the regulation.
12	**Enterprise income tax and reorganisation.** The merger, as a form of reorganisation, also involves issuing new shares in a situation where the ownership structure remains unchanged (e.g. both companies are wholly owned by the same owner). The Commercial Law does not provide for the compulsory issue of new shares while according to the definitions of the Enterprise Income Tax Law shares must be issued. At present, the importance of issuing new shares is not clear, as there is no actual impact on the application of	To develop amendments to the Enterprise Income Tax Law, it is necessary to clarify the regulation.

	the tax (as one share with the value of EUR 1 can be issued to comply with the rule of the Enterprise Income Tax Law).	
13	**Enterprise income tax and reorganisation.** At present, there are no provisions for the application of the enterprise income tax to the transitional provisions of the Enterprise Income Tax Law (e.g. old retained profits, provisions, doubtful debtors) when companies are divided or merged. For example, provisions, doubtful debtors and provisions for doubtful debtors created until 2018 may be distributed in the case of division of a company. The Enterprise Income Tax Law does not state if the right to reduce the taxable base transfers to the separated company to which a part of the positions mentioned, allowing for a reduction in the taxable base, is transferred. Moreover, it is currently impossible to reflect such transfer of assets (rights) and liabilities (obligations) in the enterprise income tax declaration.	Additions to the methodological guidelines, adjusting the enterprise income tax declaration form.
14	**Cash pool.** Unclear explanation of the cash pool financing mechanism between the group's companies. In our opinion, group account transactions are only partially in line with the definition of Paragraph 4, Section 1 of the Enterprise Income Tax Law, as they do not provide for the repayment of funds at a certain time and in a particular order. In the case of cash pool, the cash balance in group accounts changes continuously (increased by incoming cash and reduced when paying creditors' liabilities). This is a common practice used by foreign investors in many parts of the world without tax consequences.	To clearly state that if companies use a cash pool as a financing mechanism between companies in a group, including loans granted, this type of financing mechanism is not considered to be a loan to a related person if certain criteria are met, such as: (1) one of the companies in the group performs the cash function, and this is regulated by a contract between the companies; (2) the cash pool contract is concluded with a credit

		institution; 3) within the cash pool account there is an active movement of funds, which is visible on daily bank statements.
15	**Enterprise income tax.** The exemption for fuel costs set out in Clause 5, Paragraph 5, Section 8 of the Enterprise Income Tax Law may not be applied to a representation car even if it meets the criteria stipulated by law and is used in economic activity.	The enterprise income tax exemption for the costs of fuel used for representation purposes applies to a representation car as well. To this end, amendments to Sub-clause b), Clause 5, Paragraph 5, Section 8 of the Enterprise Income Tax Law are necessary, also adding a reference to Clause 3, Paragraph 1, Section 14.
16	**Enterprise income tax.** The formula referred to in Paragraph 75 of the Regulation of the Cabinet of Ministers No 677 allows for the calculation of the average value of debt liabilities over the duration of their existence, but does not take into account the duration of those liabilities from the perspective of the reporting year and gives the correct final result only when all debt liabilities have existed for a full year. In our view, in order to determine the average amount of debt liabilities during the reporting period, the taxpayer should analyse the value of the debt liability in proportion to the period in which the liability is made, namely the number of months or days in the reporting year.	To amend Paragraph 75 of the Regulation of the Cabinet of Ministers No 677.
17	**Enterprise income tax.** Companies that prepare an annual report in accordance with international financial reporting	To exclude the interest calculated in this way from the calculation of the increased interest, establishing it in

	standards and lease fixed assets are forced to recognise part of the lease payment as interest.	Section 11 of the Enterprise Income Tax Law.likuma 11. pantā
18	**Enterprise income tax and VAT.** The Enterprise Income Tax Law provides that a car with a value of more than EUR 50,000 excluding VAT is to be considered a representative car. In practice, it is often observed that the value of a car is artificially reduced in various ways in order to avoid a car being recognised as a representative car. This situation is facilitated by the fact that exceeding the fixed value of EUR 50,000 even by EUR 1 results in disproportionate enterprise income tax and VAT consequences, taxing the entire value of the car and future operating costs.	We recommend that the Enterprise Income Tax Law and the VAT Law provide that only the amount of the excess is correspondingly included in the costs not directly related to the economic activity of the taxable person and for which no pre-tax is deductible. We recommend to state in the Enterprise Income Tax Law and the VAT Law that the operational expenditure of a representative car are respectively included in the expenditures of economic activity and deductible for a 50% pre-tax if the taxpayer uses the car to perform economic activity.
19	**Assets whose purpose has been changed (enterprise income tax).** In accordance with Paragraph 2, Section 8 of the Enterprise Income Tax Law, the base taxable with the enterprise income tax includes the acquisition costs of assets acquired starting from 1 January 2018 and used for purposes not related to economic activity and the maintenance costs of those assets. In practice, the purpose of using assets may change. For example, a real estate is acquired, which is initially used for purposes not related to economic activity, but the management of the company may decide to lease or sell the real estate at market price.	To provide for how the prepaid enterprise income tax is recovered: in full or proportionally. To supplement the declaration form with an option to recover the overpaid tax.
20	**Proportionality of foreign fines (enterprise income tax).** Clause 10, Paragraph 2, Section 8 provides that fines, contractual penalties and monetary fines are expenditure	Clarification is required. Clarification of the Regulation of the Cabinet is necessary, the SRS can provide examples of proportionality. EU countries and

	not related to economic activity, if they are not proportionate. Paragraph 64 of the Regulation of the Cabinet of Ministers No 677 states that proportionate fines, contractual penalties and monetary fines are penalties imposed by public authorities. However, in other countries, proportionate fines under local regulations may be higher than those explained in the Civil Code of the Republic of Latvia. Since the interpretation of the rules that the SRS applies as a result of the interpretation of the Cabinet regulations, viewing it as a limit rather than an explanation of the principle of proportionality, is contradictory, clarification is necessary.	convention countries. To demonstrate proportionality by other means.
21	**Low-value representation items (enterprise income tax, VAT).** The Regulation of the Cabinet of Ministers No 677 states that low-value representation items are worth up to 20 EUR, while the VAT Law states an amount of 14 EUR. Consequently, a situation may arise in which the item for one tax is a representation expenditure and for the other tax it is an expenditure non-related to economic activity.	Proposal to develop a common approach to the classification of expenditure for the purposes of enterprise income tax and VAT.
22	**Amount of share capital (enterprise income tax).** Under Section 155 of the Commercial Law, a mark-up of shares is not to be included in share capital, which raises a number of problems: (a) Section 4, Sub-clause 8 of the Enterprise Income Tax Law provides that the liquidation quota or conditional dividend is calculated on the difference in equity with the amount invested by the members, where the amount invested by the members does not include a share	Given that the share mark-up is a real contribution by the members, we believe that the provisions of the Enterprise Income Tax Law and the Commercial Law should be clarified by providing that in the above mentioned cases share capital characteristics are applicable to the share mark-up, and this should therefore be used: a) when calculating the payment taxable with enterprise income tax to the participants

	mark-up; (b) Section 11 of the Enterprise Income Tax Law provides that a loan granted to a related person is subject to enterprise income tax, unless it does not exceed the share capital recorded at the beginning of the reporting year; (c) Section 204-208 of the Commercial Law provides for the possibility of reducing the share capital, but the participants are not able to reduce the mark-up of the shares of the equity.	in case of liquidation; b) for calculations on the loans granted to participants; and c) when a reduction in the share capital is made.
23	**Doubtful debtors incurred until 31 December 2017. (Enterprise income tax).** Paragraph 31 of Transitional Provisions does not include all possible situations in relation to doubtful debtors. For example, the Transitional Provisions provide that the taxable base of the enterprise income tax for doubtful debtors may be reduced if they comply with Section 9 of the Enterprise Income Tax Law and are written off, but do not provide for reducing the base taxable with enterprise income tax if such debtor is recovered. Given that the SRS has issued references indicating that the base taxable with enterprise income tax can also be reduced for recovered debtors, it is advisable to clarify the wording of the law by indicating this.	To clarify the legal provisions by covering different scenarios for the movement of provisions of "old" debtors. The explanation should be included in the law.
24	**Immovable property tax.** Upon comparing the situation in the Baltic States in connection with the activity of a group of companies, differences in the amount of the immovable property tax during the process of reconstruction can be identified. In Latvia, while the immovable property is in reconstruction and consequently no economic activity is	For a reconstruction period not exceeding 12 months, the company should receive a tax allowance of up to 100% of the immovable property tax. Such a tax allowance of the immovable property tax for the period of reconstruction should be statutory. In the interests of long-term investors, the provisions of the

	carried out at this stage, the company must pay the full amount of immovable property tax.	immovable property tax allowances must be clear, transparent and without any possibility of discrimination depending on the municipality or company. The property may be granted a limited period for the immovable property tax allowances in the case of reconstruction, for example every five years.
25	**Enterprise income tax.** The accounting of provisions for doubtful debtors and the need to track the 36-month period will impose a heavy administrative burden on both entrepreneurs and the SRS. Companies that could potentially deliberately divert profits by selling goods/services without receiving payment for it, will bypass this norm, without creating provisions, but in such cases the profits will nevertheless be taxable upon distribution. On the other hand, companies whose accounts are checked by certified auditors create provisions in accordance with the requirements, so this provision imposes a burden without the return of the enterprise income tax.	To waive the need to include provisions for doubtful debtors in the taxable base. Instead, to provide for other rules against evasion, such as preventing the formation of doubtful debtors with related parties or stipulating that an unreasonable and long-term provision to the doubtful debtor may also be regarded as a reduction in the size of the profit base, and to impose an obligation to write-off the debtor if no payment has been received within X years of the transaction.samaksa X gadu laikā kopš darījuma veikšanas.
26	**Enterprise income tax.** Under the Enterprise Income Tax Law, expenditures of economic activity also include "the objects which contain merchant brand and are added to the product in order to promote demand for it and the value of which do not exceed EUR 70 or five per cent of the value of the product advertised as part of an advertising campaign". It has not been stated whether the value of 70 EUR is the acquisition value or the selling price, and what happens if	In practice, the interpretations of the SRS differ, and it is necessary to include clarifications in Clause 2, Paragraph 7, Section 8 of the Enterprise Income Tax Law.

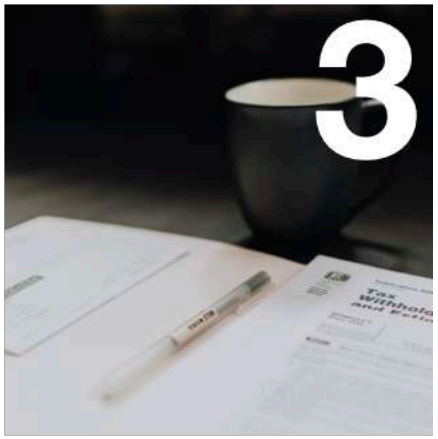
	the added item exceeds the limit (i.e. should the entire value of the added item or only the excess be taxed, is it an object taxable with enterprise income tax, should the recipient be identified and be taxed with personal income tax (the latter would, of course, be impossible).	
27	**Enterprise income tax.** High effective enterprise income tax rate in cases of regular dividend pay-outs.	If a company pays out dividends on a regular basis, a lower enterprise income tax rate is applied (following the example of Estonia).

PRIORITY B		
28	**Enterprise income tax.** Limited use of tax losses.	To provide for an extension of the possibility of using tax losses (10 years as a proportionate period). To allow the transfer of tax losses in the case of reorganisation: company transitions, mergers and divisions.
29	**Enterprise income tax and VAT.** At present, with the tendency to save the increasingly dwindling and nature-polluting resources, electric vehicles and widening the opportunities for their use have become a topical theme. However, the Enterprise Income Tax Law and VAT Law do not contain provisions relating to electric vehicles and their use in the taxpayer's economic activity. The inclusion of these provisions could facilitate the use of electric vehicles in business activity.	We recommend to supplement the provisions of the Enterprise Income Tax Law and VAT Law by including references to electric vehicles and by providing that the sale of electric vehicles is not subject to VAT or that the taxpayer is entitled to deduct as a pre-tax from the amount of tax to be paid into the state budget the entire amount of tax on the purchase and maintenance of the electric vehicle if the electric vehicle is used in the taxpayer's economic activity. Similarly, the Enterprise Income Tax Law should provide that expenditure relating to the purchase and maintenance of an electric vehicle is expenditure

		directly linked to the economic activity of the taxpayer if the electric vehicle is used to ensure the taxpayer's economic activity.
30	**Proportionality of fines (enterprise income tax).** Clause 10, Paragraph 2, Section 8 provides that fines, contractual penalties and monetary fines are expenditure not related to economic activity, if they are not proportionate. Paragraph 64 of the Regulation of the Cabinet of Ministers No 677 states that proportionate penalties are those that do not exceed the amount of statutory interest specified in the Civil Code. Contractual penalties are not the same as statutory interest. There are no explanations or guidelines to determine whether the penalties do not exceed the statutory interest, e.g. there are no guidelines for determining whether the fine of the manager of a building for losing an employee's entry card is considered to be proportionate.	Clarification is required, to be specified by Cabinet regulations.
31	**Loan amount (enterprise income tax and personal income tax).** "(5) The base taxable with the enterprise income tax in the taxation period shall be reduced by the amount of the repaid loan if the amount of the loan has been included in the base taxable with the enterprise income tax in any of the pre-taxation periods, or the loan has been taxable with the personal income tax in accordance with Section 8.1 of the law On Personal Income Tax." There is no such derogation in the law On Personal Income Tax. In reality, the effects of the enterprise income tax are	Proposal: to develop a common approach to the needs of personal income tax and enterprise income tax (i.e. if one tax is applied, then the other should not be applied). The rules need to be coordinated.

	most often more likely to occur more quickly than the effects of personal income tax. Since there is no provision in the law On Personal Income Tax that would prevent double taxation with personal income tax, a situation may in fact occur where the loan is subject to enterprise income tax and, after a certain period, is also subject to personal income tax. The tax paid can be recovered only when the loan is repaid.	
32	**Enterprise income tax and permanent establishments.** When the main company located in Latvia has permanent establishments abroad, according to Section 4 of Enterprise Income Tax Law the taxable basis is formed by summing up the objects calculated in Latvia and abroad during the taxation period. On the other hand, the basis for calculating the 5% limit on the expenses of sustainable activities of personnel is the gross wages only for employees working in the main company. Thus, companies with permanent establishments abroad have a less favourable legal framework.	Clarifying amendments to the Cabinet regulations are required.

Recommendations by sections



Value added tax, excise duty, customs duty, lottery, and gambling tax

Group 3	Issue	Solution
1	**VAT.** For businesses, the correction of VAT declarations on services received from taxpayers from another Member State, third countries or third territories is a problem, since, according to Section 122 of the VAT Law, VAT on those services must be indicated in the declaration at the time when the service is received or the payment is made in advance. Very often, the invoice is received after the service is received, which results in constant corrections to VAT declarations. This greatly increases the administrative burden on businesses and creates problems in automating the process of preparing VAT declarations.	In order to reduce the administrative burden on businesses, as well as to make it possible to automate the process, we propose changes to the VAT law. To enable companies to choose to declare VAT in the tax declaration of the tax period in which the service and the invoice for the service is received.
(1) Comment	Following negotiations with the Ministry of Finance, for efficiency reasons Paragraph 1 has now been removed from the agenda.	

2	**VAT.** For foreign companies in Latvia, the problem arises from the fact that it is practically impossible to declare transactions carried out in Latvia voluntarily without excessive penalties if the foreign company has not registered in time in the Latvian VAT register, i.e. before the transactions are carried out in Latvia. Latvia is one of the few EU Member States where retroactive VAT registration is not possible. On the other hand, the declaration of transactions carried out before registration in the VAT register and the deduction of the pre-tax for them are substantially limited: namely, for transactions carried out before VAT registration, the pre-tax is either not deductible at all (e.g. if goods purchased before the registration have already been sold) or there is a significant burden associated with it, for example, goods for which deduction of pre-tax is needed, must still be at the disposal of the company (in stock). This has led to a situation whereby a foreign company rarely chooses to voluntarily declare VAT taxable transactions in Latvia if this has not been done duly, because the penalties are excessive: even not allowing to deduct the pre-tax at all, which is contrary to the basic principles of the VAT directive and the case-law of the CJEU.	To make changes to the VAT Law by providing for: 1) The possibility of registering in the VAT register retroactively (and applying the provisions of the VAT law to both the transactions carried out and the goods/services received, namely, by allowing the deduction of the pre-tax on taxable transactions, provided that the pre-tax is used for taxable transactions); or even if it is not possible to register retroactively, make changes to the deduction of the pre-tax for transactions carried out before VAT registration, applying the late payment charges of the Law on Taxes and Duties, but allowing the deduction of the pre-tax on transactions taxable with VAT and carried out before VAT registration, in accordance with the case-law of the CJEU.
3	**VAT.** Import permit for VAT transactions is not available to foreign merchants. This was recently introduced into law (the range of persons who can obtain these permits was reduced) on the basis of	Import VAT permit: it should also be possible for foreign merchants to obtain it.

	fight against fraud. The existing regulation discriminates against foreigners compared to domestic companies.	
4	**Excise duty on non-alcoholic beverages.** It is disproportionate to highlight a specific group of products, i.e. non-alcoholic beverages, without a national population dietary habit study on the percentage of added sugar, salt and fat in the diet. The introduction of the increased rate of excise duty on sweetened non-alcoholic beverages alone will increase the risks of foregone revenue of cross-border trade and the national budget, as is currently the case in the beer and spirits sectors. The increased rates for non-alcoholic beverages are disproportionate compared to beer and spirit rates, creating a situation in which the consumption of alcoholic beverages is actually encouraged.	The Ministry of Health needs to conduct a comprehensive national study on population dietary habits, identifying the main causes of obesity and the possibilities for improving the composition of foodstuffs in order to reduce excessive fat, sugar and salt content in foods. Evaluating the informative report of the Ministry of Health, the Ministry of Finance needs to consider the creation of new groups of excise products or making changes to existing ones, setting appropriate excise tax rates. The product group currently offered, i.e. sweetened non-alcoholic beverages, is discriminatory in view of the proportion of added sugar in other product groups.
4A	**Excise duty on beer.** Uncoordinated excise rate policy for related groups of excise goods, i.e. beer and spirits, can lead to adverse public health effects: implementing opposite changes in excise duty rates for beer and spirits undermines long-term public health policy.	When making changes in excise duty rates within the food group, it is necessary to take into account long-term public health policy considerations without making any contrary changes to the rates of excise duty. In the context of the reform, it is necessary to align the ratio between the excise rates for beer and spirits by increasing the rate of excise duty on spirits, taking into account the developments of the changes previously specified in the national tax policy guidelines.
5	**Excise duty.** *On Excise Duty: Section 14*	In order to increase the income of excise duty in the

	The different rates of excise duty on oil products in the Baltic States have a significant impact on the volume of sales of fuel in the border area of Latvia, as well as have a negative impact on the transport sector as a whole (especially in the field of international freight transport). The increase in excise duty planned on 1 January 2020 will significantly increase the difference in fuel prices between Latvia and Lithuania. Fuel price difference: 8-9 cents. This will have a significant impact on the volume of fuel sold in the border area of Latvia and will consequently affect the revenue from excise duties.	Latvian state budget (by increasing fuel demand in Latvia) and to maintain and improve competitiveness in the oil trade sector with the nearest neighbouring countries (Lithuania, Estonia, possibly also Poland), it is necessary to create and synchronize excise tax policy for oil products at a transnational level, agreeing on a common strategy – increasing taxes in equal amounts.
6	**Excise duty on tobacco products.** The illegal movement of excise goods is a serious problem in Latvia, threatening the revenues of the state budget, adversely affecting legal business activity, and undermining the objectives of public health policy. A well-thought-out development of future tobacco excise tax policy, together with targeted and coordinated work by law enforcement authorities, including the development of an effective penal policy, are important factors in reducing cigarette smuggling. The illegal market for cigarettes is causing damage to the Latvian state budget of approximately EUR 60 million, while at the same time posing a threat to public health as well as to national security.	Tobacco excise duty policy must be developed in the long term, taking a gradual (raising the tax to 5% per year) and predictable approach. Following the recommendations of the World Bank, continue to reduce the percentage component of the cigarette excise duty by increasing the specific component proportionately and ensuring an effective minimum excise duty. Such a complex approach (predictability, gradual increase in tax, changes in the structure of cigarette excise duty) would generate predictable and increasing excise revenues, strengthen the fight against illegal trade and have a positive impact on public health objectives.
7	**VAT rate for fresh foods.** High retail prices for food products create a large grey area in the grocery sector,	To reduce the VAT rate (5%) for fresh food products (fresh fish, meat, eggs and dairy products), thereby reducing the grey sector of the food market, boosting

	thereby undermining the competitiveness of local producers on store shelves. The most direct effect of high prices of food products is on the most vulnerable groups in society, for which support will be particularly important during the economic crisis caused by the COVID-19 pandemic. In most European countries, a reduced (0-14%) VAT rate for food products is already in force, dealing with the above issues, but in Latvia the rate cut currently affects only a very small group of products.	the competitiveness of local producers and supporting the lowest income groups.

Recommendations by sections

Tax administration

Group 4	Issue	Solution
1	**Tax administration.** *On Personal Income Tax* Employees with variable working hours have different personal income tax rates (20%/23%) and the total amount of annual income. A variable amount of income every month means that it is possible to owe the SRS at the end of the year, even though all taxes are paid monthly. *On Personal Income Tax: Section 12* Inaccurate estimated non-taxable minimum for students and/or mothers. It is still up to the company to control wages, which are not subject to the non-taxable minimum.	To introduce an option for indicating gross wages as salary as well, when submitting information on a new employee in the EDS. To connect the reports on mandatory state social insurance contributions and the personal income tax statement in relation to payments to non-residents. To introduce an option that allows the employer to know about this type of change in due time – by

	On Personal Income Tax: Section 4 Th report on employees who become residents from non-residents. The SRS makes retroactive changes, but these changes do not allow employees to claim overpaid taxes using an annual declaration because reports on the mandatory state social insurance contributions and the personal income tax statement on payments to non-residents are not connected (furthermore, both are submitted for different tax periods). *On Personal Income Tax: Section 4* Change of status of tax residents. The company becomes aware of the fact that the employee has changed the status of the tax resident upon submitting reports to the SRS, where an error message is received. A similar situation occurs when an employee changes the tax identification number to a personal identity number. We only learn about the changes upon submitting reports and receiving an error message.	receiving a message from the SRS (before reports are submitted and error messages are received).
2	**Changes in tax policy.** Unpredictability in shaping and implementing tax policies.	When taking decisions that will have a significant impact on economic sectors essential to the Latvian economy, we invite decision-makers to discuss with the industry in due time and to find a sustainable solution together. Tax changes announced only three months before the new arrangements come into force undermine the competitiveness of businesses, the confidence in a stable business environment and the ability to plan their activities in the short and long

		term.
3	**Tax administration.** Practical application, interpretation for entrepreneurs who do not have consultants.	SRS guidelines and explanations are required. To involve relevant associations and organisations in consultation before guidelines are drawn up. To involve the industry in due time and to respect the principle of transparency.
4	**Administration of immovable property tax.** If a company has a tax related question, it usually turns to the SRS. If the company has a specific question on the immovable property tax, often the SRS cannot help, and it is necessary to consult the local authority (e.g. the Municipal Revenue Office of Riga City). Questions tend to be complicated, but we know from experience that questions about a tax of EUR 200,000 for a company and a 50 EUR tax for a natural person are reviewed in a common order. Municipalities do not have departments or specialists for "large immovable property taxpayers".	Proposal: to establish guidelines and an equivalent approach from the state and local authorities to determine the burden of the immovable property tax.
5	**Administration of immovable property tax.** Real estate developers have repeatedly faced a situation where, at the calculation of cadastral depreciation after the reconstruction of a building, specialists of the State Land Service allocate low depreciation rates to the structural elements of buildings that were not involved during the respective reconstruction. As a result, the cadastral value of the building and, consequently, the annual amount of the immovable property tax are artificially inflated. Companies are forced to formally contact the State Land Service with requests to correct such errors, taking up time and resources; moreover,	Proposal: to draw the attention of relevant State Land Service specialists to the calculation of cadastral value components, including their impact on the immovable property tax.

	during this process the company must pay the unduly increased immovable property tax.	
6	**Tax administration.** With the introduction of a single tax account from 2021, the tax payment will be administered automatically. When the Director General of the SRS decides (as a result of a challenge) on a surcharge, the tax debt must be paid regardless of the filing of a claim to the court. Under the existing framework, the single tax account primarily covers the oldest obligation. Thus, if the company cannot cover the surcharge, other tax debts will also be incurred. As a result, it is likely that the taxpayer *[unless interim measures are granted (where the decision is prima facie unlawful), which should not be the norm in any case]* will not actually be able to exercise his or her right to appeal in court against the decision of the Director General of the SRS. This infringes the right to a court as defined in Article 92 of the Constitution in a situation where the taxpayer is objectively unable to pay the debt.	To provide for an exception by determining non-routine arrangements in Paragraph 5 of the Regulation of the Cabinet of Ministers No 661 "The arrangements for paying taxes, duties, other state charges and related charges and directing them to cover liabilities" in relation to surcharges applied by the SRS if the decision of the Director General of the SRS is appealed to the court.
7	**Tax administration.** In a situation where an error has been made (including as a result of the interpretation of the law) but there is no risk of non-payment of tax, the taxpayer must, in certain cases, practically pay a penalty in the form of a tax.	If, as a result of the activities of the taxpayer, it is not apparent that the budget has been harmed or that the taxpayer has benefited from the tax, then the SRS does not apply a tax surcharge (consequently, there is no late payment charge).

FICIL Position Paper No. 4

Foreign Investors' Council in Latvia Position on Tax Policy and Tax Administration

FICIL is a non-governmental organisation that unites 38 largest foreign capital companies from various industries, 10 foreign chambers of commerce in Latvia, French Foreign Trade Advisers and Stockholm School of Economics in Riga. The goal of FICIL is to improve Latvia's business environment and overall competitiveness in attracting foreign investment, using the experience and knowledge of its members to provide recommendations to Government and state institutions.