



FICIL
RAISE THE BAR!



Position No. 8

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

16 September 2021



Executive Summary

Foreign investors still name the Latvian tax system and its unpredictability as one of the main impediments for improving the investment environment in Latvia¹. In 2020, most investors said that, in their opinion, there has been no improvement in the quality of the tax system. It is crucial to highlight the growth of the shadow economy as well. The results of the latest study regarding this topic show that the shadow economy reached 25.5 % of the Latvian GDP in 2020, the highest point since 2011². Willing to promote the reputation of Latvia as an investor-friendly country that is attractive for business, the Foreign Investors' Council in Latvia (hereinafter – FICIL) provides its recommendations on improving the tax system and increasing tax predictability.

First, FICIL highlights the need for a long-term approach to tax policy planning. Considering that companies plan their investments looking several years ahead, the ability to rely on a unified approach to the tax system as well as predict possible tax changes during a particular planning period is crucial to them. A longer-term strategy would not only provide companies with the

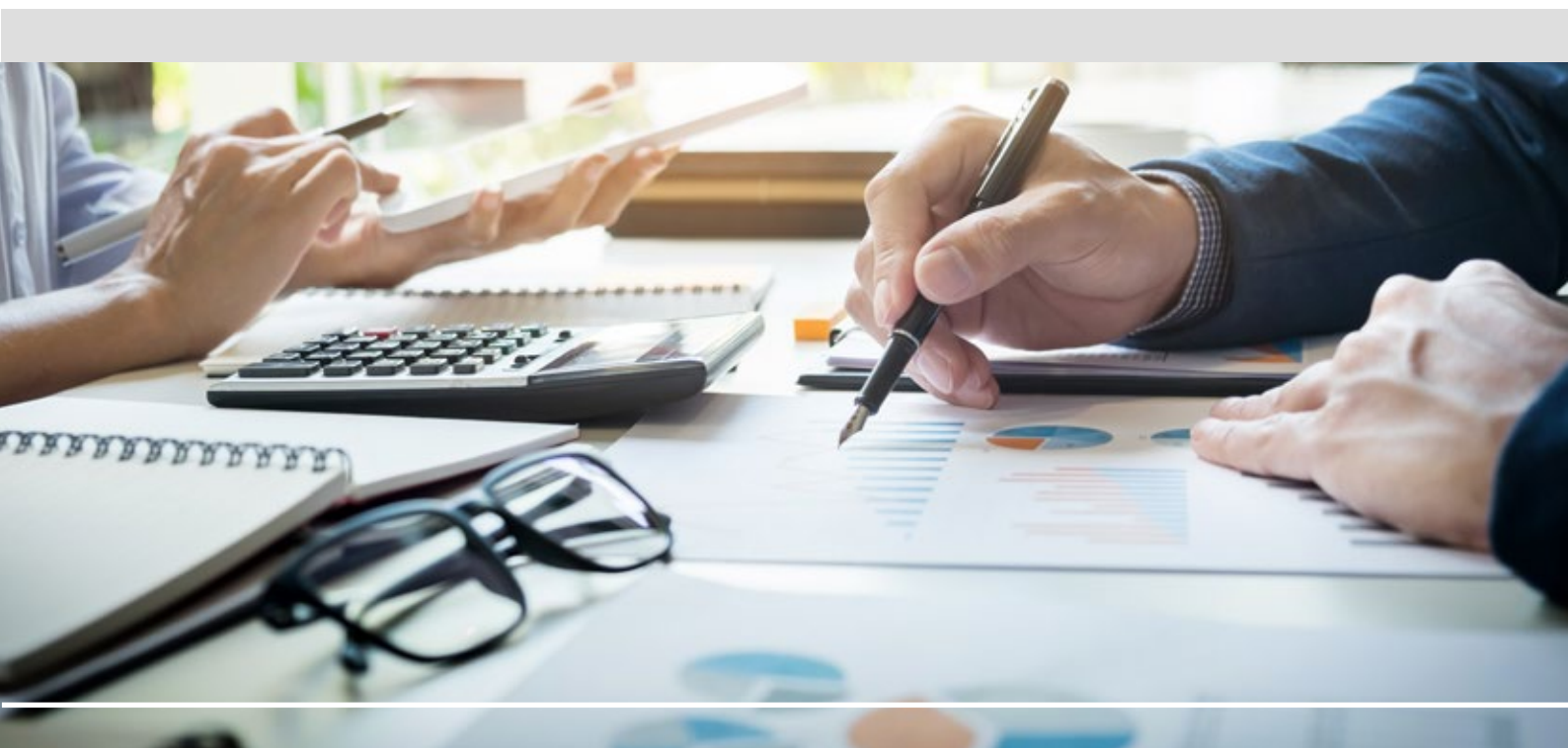
idea of potential changes, but also improve the public sector's communication with society, justifying and explaining the necessary changes.

Likewise, it is necessary to understand the effects of global tendencies on the Latvian economy and tax system. A thought-out long-term strategy would enable Latvia to act proactively to ensure that changes in the European and global economy place Latvia in a better position compared to other countries of the region, rather than create excessive administrative and financial burden.

FICIL reiterates its detailed suggestions in the following recommendation groups: 1) personal income tax and mandatory state social insurance contributions; 2) corporate income tax; 3) tax administration. In this section, FICIL recalls the recommendations already presented in 2020, emphasising those that, in our opinion, should have the biggest impact on the improvement of the tax system.

¹ https://www.ficil.lv/wp-content/uploads/2021/01/LV_2020_FICIL_Sentiment_Index.pdf

² https://www.sseriga.edu/sites/default/files/2021-06/SSERiga_Enu_ekonomikas_indekss_2009-2020.pdf



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Longer-Term Tax Strategy

To ensure the development of the Latvian tax system based on predictability, transparency and public involvement, FICIL encourages revising the government's existing approach to development of the tax policy and recommends creating a longer-term tax strategy, which will:

- 1) promote transparency of tax initiatives via an open and transparent cooperation process, changes based on data analysis according to modern goals, and discussion with taxpayers on consequences caused by previously planned changes;
- 2) ensure a proactive and appropriate response to global tendencies;
- 3) improve the tax planning process, linking it to other long-term planning documents of the state and preserving the hierarchy of these documents;
- 4) help to create a substantive cooperation of the state administration in the field of taxes both within itself and with the private sector.

Foreign investors have long emphasised uncertainty as one of the main factors delaying development of the Latvian investment environment³. Investors consider that the non-transparency of the Latvian tax system plays a great role in this uncertainty. To reduce the negative effects of this factor, FICIL believes that it is necessary to develop a comprehensive tax strategy for the next five years, which would define the attainable goals, explain their quantitative and qualitative impact on the development of the business environment, and activities for their attainment.

Involvement of society and businesses in the discussion of tax initiatives in the early stages would promote the transparency and predictability of the Latvian business environment. In this context, FICIL considers that tax change initiatives affecting taxpayers should be announced at least 18 months before they enter into force. Only after discussing and approving the initiatives, the wording of a legal act should be drawn up. It is important to highlight that taxes changed during the planning of the state budget are still tax changes that affect the ability of companies to plan their budget and expected tax payments. It is necessary to acknowledge the state budget planning period and the fact that any tax changes within this period actually mean the need of companies to re-plan their budget for the upcoming year. Thus, legal acts on taxes and supplements or amendments thereto in their final wording should be available to taxpayers at least eight months before they enter into force, except for cases when more favourable norms are introduced.

Such longer-term strategy is even more necessary considering various external factors. Among these

factors are, for instance, the EU Green Deal, EU digital tax incentives, recommendations of the Organisation for Economic Co-operation and Development, the global minimum corporate income tax or the goals of the Recovery and Resilience Facility. It is currently observed that the Latvian tax policy guidelines do not comply with said EU and global tendencies.

FICIL considers that Latvia should form a proactive opinion and inform in a timely manner about its position on the effects of external factors on the country's tax system. Simultaneously, this opinion should correlate with previously adopted planning documents to ensure that the business environment in Latvia is predictable and promotes long-term investment. For example, when transposing requirements of EU directives in the national regulatory framework, it is necessary to understand the true final goal of the requirements. There is a need to ascertain that no unnecessary administrative burden is created for companies and that Latvia exercises its right to introduce special norms to ensure a more flexible and development-promoting business environment.

Likewise, it should be emphasised that companies which make long-term investments rely on industry planning documents previously adopted by the Government. For purposes of promoting the predictability of the business environment, it should be ensured that any changes in the tax system are discussed in context with these planning documents, particularly with the National Development Plan. Each and every initiative should have a clear goal and measurable results, as well as particular steps and deadlines to reach the objectives. Moreover, this goal should be closely related to other planning documents.

This can be promoted by giving the responsibility over the tax priorities and objectives in a particular industry to the corresponding ministry. FICIL believes that the ministries responsible for achieving certain objectives in the industry should also govern the tax objectives, performance criteria and steps to achieve them. At the same time, it is necessary to highlight the benefits provided by the separation of the tax policy and budget planning. Considering that the competence of the Ministry of Economics includes the promotion of business activity, FICIL believes that this ministry should undertake the primary responsibility for tax policy, whereas state budget planning should remain within the competence of the Ministry of Finance. It will, first of all, ensure a government-level dialogue, wherein the needs of the state budget as well as measures necessary for promoting business activity are considered equally. Secondly, the division of competences would promote the development of a long-term approach to tax policy, separating it from the annual budget planning.

³ https://www.ficil.lv/wp-content/uploads/2021/01/ENG_2020_FICIL_Sentiment_Index.pdf

Recommendations by sections

Group 1 – Personal income tax, mandatory state social insurance contributions

	Issue	Solution
1.1	<p>Personal income tax and mandatory state social insurance contributions. 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.</p> <p>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.</p>	<p>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).</p>
1.2	<p>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:</p> <ol style="list-style-type: none"> 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. 	<p>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.</p>
1.3	<p>Personal income tax and mandatory state social insurance contributions. The existing system for calculating labour taxes is difficult for many taxpayers to understand.</p> <p>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.</p>	<p>To simplify the calculation system for personal income tax, social contributions and solidarity tax.</p> <p>The solidarity tax should be combined with the personal income tax.</p> <p>To set a fixed non-taxable minimum depending on the amount of annual income.</p> <p>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.</p>

Group 2 - Enterprise income tax

	Issue	Solution
2.1	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 one. 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.
2.2	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.
2.3	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.
2.4	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 the permanent establishment (branch), and makes the branch an unattractive form of business in Latvia.	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.
2.5	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.
2.6	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.

Group 3 – Tax administration

	Issue	Solution
3.1	<p>Tax administration.</p> <p><i>On Personal Income Tax</i></p> <p>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.</p> <p><i>On Personal Income Tax: Section 12</i></p> <p>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.</p> <p><i>On Personal Income Tax: Section 4</i></p> <p>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).</p> <p><i>On Personal Income Tax: Section 4</i></p> <p>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.</p>	<p>To introduce an option for indicating gross wages as salary as well, when submitting information on a new employee in the EDS.</p> <p>To connect the reports on mandatory state social insurance contributions and the personal income tax statement in relation to payments to non-residents.</p> <p>To introduce an option that allows the employer to know about this type of change in due time – by receiving a message from the SRS (before reports are submitted and error messages are received).</p>
3.2	<p>Changes in tax policy. Unpredictability in shaping and implementing tax policies.</p>	<p>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.</p>



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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.

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