

New rules for income tax returns (3/37/18)

The Cabinet of Ministers' new Regulation will already apply when completing the income tax return for 2018. This article explores key changes to the procedures for completing the annual income tax return. We will discuss changes affecting traders in a separate article.

Having studied the draft Cabinet Regulation and its annotation as well as the new annual income tax return form, we conclude that there are plans to shed more light on a number of areas where the right way of applying provisions of the Personal Income Tax (PIT) Act is not so clear. This holds true especially for allowable expenses.

Claiming allowable education and medical expenses

Amendments to the PIT Act effective from 1 January 2018 have made the following changes to the procedures for claiming allowable expenses:

1. The taxpayer's own limit on allowable education and medical expenses and donations is 50% of taxable income, capped at €600;
2. This cap also applies separately to each of the taxpayer's family members whose education and medical expenses are included on the taxpayer's annual income tax return;
3. The cap includes amounts spent on dental services and scheduled operations.

Currently a refund of PIT on allowable expenses is calculated as 20% of the expenses, i.e. a taxpayer with €1,000 in allowable expenses will have a refund of €200.

Below are key points that follow from the draft Cabinet Regulation and its annotation:

1. If a taxpayer includes on their annual income tax return any expenses incurred by their family members, then total allowable expenses cannot exceed 50% of the taxpayer's taxable income. The €600 cap applies to each family member and the taxpayer separately (€600 each). For example, the total cap for a person with three family members would be €2,400 as long as it does not exceed 50% of the taxpayer's taxable income;
2. The taxpayer's annual income tax return may include a family member's education and medical expenses but cannot include any donation the family member has made. The family member should include such donations on their own annual income tax return to claim relief and obtain a PIT refund;
3. Since donations as well as education and medical expenses are covered by the same cap, all of them should be entered on Annex D4 to the annual income tax return. However, only excess education and medical expenses may be carried forward. The Cabinet Regulation says there is no carryforward for donation expenses, and they are the first to utilise each tax year;
4. Since the old PIT rules allowed any excess education and medical expenses to be carried forward to the next five (now only three) tax years, there was uncertainty about carrying forward expenses included on the annual income tax return for past years. The annotation explains that the new annual income tax return form should make it possible to utilise any expenses incurred before 2018 for five years. According to the established practice and the new annual income tax return form, we believe the cap of €600 should apply to any allowable prior-year expenses brought forward. However, no such instruction is included in the Cabinet Regulation or its annotation.

The progressive rate and recalculation

The Cabinet Regulation confirms that the progressive rate is applied to employment income and any other income for which the PIT Act (Section 15 of the PIT Act) does not prescribe a fixed rate, ignoring these expenses in calculating the progressive rate. The calculation should also ignore any non-taxable income specified by section 9 of the PIT Act and any foreign employment income that is exempt in Latvia under section 24(7) of the PIT Act.

The proposed annual income tax return form also includes a weighted average rate calculation to measure how much PIT is additionally payable on any foreign income that has been subject to income tax in the source country (if the Latvian weighted average is lower than the foreign one).

Reporting borrowings treated as income on the annual income tax return

If a taxpayer has borrowed an amount that is treated as income under section 8.1 of the PIT Act, then that amount should be included in income attracting both the progressive rate and a 22% surcharge.

In practice, to apply both the progressive rate and the surcharge, the income should be reported twice on annexes to the annual income tax return:

1. Annex D1 or D2, depending on whether the income is from a Latvian or a foreign lender. So the income will go into column 1 or 2 of Sheet D and be taken into account when calculating the progressive rate;
2. Annex D1.1 for applying the surcharge. This annex should also state the rate of 22%.

Solidarity tax recalculation

We have written about arrangements for recalculating a person's solidarity tax liability through the annual income tax return. Annex D1 should continue to include any Latvian national insurance contributions paid and deducted from remuneration and the employee part of solidarity tax with no adjustment. Solidarity tax adjustments will be made on Sheet D:

- The part of solidarity tax transferred to PIT will be subtracted from the employee part of national insurance contributions and solidarity tax on line 5; and
- The part of solidarity tax will be added to the PIT withheld in advance on line 19.

The part of solidarity tax transferred to PIT will not go into a separate column on Sheet D. However, since the annual income tax return form available from the Electronic Declaration System has so far shown subsections populated with data available to the SRS, information about the exact part of solidarity tax transferred to PIT is likely to appear in any of the subsections under line 5 and/or 19 of Sheet D.

A solidarity taxpayer wishing to complete the annual income tax return on paper will be able to obtain from the SRS accurate information about the adjusted employee part of solidarity tax. The Cabinet Regulation states that information about the part of solidarity tax paid into the PIT distribution account will be made available within one month after receiving the taxpayer's request, but no earlier than 1 April.

¹ Family members are parents, grandparents, spouse, children and grandchildren under section 8(2.3) of the PIT Act.