# Property market begins to revive (1/40/18)

We have seen Latvian and foreign corporate and private investors enquiring about ways of buying real estate (RE) in Latvia. A few years ago we saw investors mainly from CIS countries, but their profile has recently diversified to include China and Japan as well as the CIS and Nordic countries. Major RE brokers have experienced similar trends. Such investments may have various aims, but mainly these are RE leases with a view to appreciation and sale to receive the expected return on investment. This article explores the main tax issues an RE investor wants to analyse before buying RE in Latvia.

Buying RE vs buying an RE company

Given Latvia's historical practice of placing RE investment in a separate company that often not only holds the RE but also manages it, this is usually the first question asked by investors planning for the tax implications of their RE acquisition and potential sale. But the investor's choice may depend on the seller's choice of selling RE or an RE company. The following aspects should be considered:

1. The Cabinet of Ministers' Regulation No. 1250 on stamp duty for entering ownership and mortgage rights on the land registry has been amended with effect from 1 May 2018 to provide that a 2% stamp duty without restriction (previously capped at €42,686.15) is also payable on the disposal of any land and buildings comprising a non-residential part only. These changes often cause investors to go for acquiring an RE company. This means a higher risk of potential liabilities and the risk of incorrect tax treatment.
2. If RE located in Latvia or a Latvian RE company is sold to a non-Latvian tax resident (an individual or entity), the individual is liable to pay personal income tax (PIT) and the entity pays corporate income tax (CIT) at a rate of 3% of the sales proceeds. The CIT Act permits EU residents and residents of a country that has an effective double tax treaty with Latvia to recalculate and recover the 3% tax paid. An alternative calculation measures the gain arising on the sale of RE as sales proceeds less any documented selling expenses and applies a 20% tax. If no profit arises on the sale of RE, the non-resident can recover the 3% tax paid fully or partly.
3. From 2018, any profit a Latvian company makes from selling RE or an RE company is exempt from CIT until paid out in dividends. The Latvian company can reinvest such profits into its business without paying CIT. If the Latvian company has held shares in the RE company for 36 months or longer, even dividends paid out of those profits will escape CIT. This allows the investor to profit from selling an RE company in a tax effective way. But an individual receiving dividends should still pay a 20% tax under the PIT Act. The Latvian company is responsible for withholding such tax.
4. The VAT treatment of RE sales is closely linked to RE status. For example, the sale of development land, or unused RE as defined by article 1(12) of the VAT Act, attracts VAT. The sale of land (without development rights), used RE, or an RE company, is exempt. The VAT treatment is crucial to investors planning RE deals without the right to deduct input VAT.

A cash contribution to share capital vs a loan

This issue comes into play only if investors decide to buy RE or an RE company through a Latvian-registered company. Although the question of financing is often closely linked to external factors such as the availability of a bank loan and the desire to protect investments, investors have the option of contributing the available funds to share capital or lending to their company. The following aspects should be considered:

1. A newly formed company should have a minimum share capital of €2,800.

2. The CIT Act restricts the deduction of interest on loans that are not issued by a bank or another institution whose loans enjoy special conditions under the CIT Act. These restrictions (article 10 of the CIT Act) impose an obligation to include as deemed profit distributions in the CIT base any interest payments that exceed –

a) interest payments in proportion to the extent that the average debt liabilities for the financial year (on which interest has been charged) exceed four times the shareholders' equity at the beginning of the financial year less any non-current investment revaluation reserve and other reserves that have not resulted from profit distributions;

b) interest payments exceeding 30% of the pre-tax profit reported in the profit and loss account for the financial year plus interest payments and depreciation if interest costs exceed €3 million for the financial year.

3. Loan interest that a Latvian company pays to a related party should be arm's length.

So the choice of investing in a Latvian company only with a loan or with small contributions to share capital creates an additional tax burden on the company. Unless we are talking about an existing company with a sufficient level of shareholders' equity, investors tend to split their investment between a contribution to share capital and a loan.

We have just briefly described the tax aspects we commonly discuss with investors, but the list is not exhaustive because each transaction is unique and may have different tax implications. We also see that the decision on the form of acquisition is often affected more by business considerations and the parties' agreement on the legal form of the transaction than its tax aspects.