Tax authority exempts personal income tax on dividends from Latvian company actually received out of income arising before 2018 (2/9/19)

In late 2018 and early 2019 the State Revenue Service (SRS) published anonymised rulings on the tax treatment of dividend income. Last week we wrote about one of them, and now we are commenting on the other. What the two rulings have in common is the type of income whose tax treatment is being analysed and the approach the SRS takes to interpreting the law without taking the option under the Personal Income Tax (PIT) Act to analyse the transaction or the group structure according to its economic substance. This article explores SRS findings about the CIT and PIT treatment where a dividend paid out of a Latvian company's profit for 2017 is included in another Latvian company's profit for 2018 and then paid to an individual.

The ruling of 18 December 2018[1] resolves the PIT treatment of a dividend the individual receives through a chain of companies after 2017, which is ultimately sourced from a profit arising before 2018.

Background

X, a Latvian company owned by a Latvian tax-resident individual, has a 55% shareholding in Y, another Latvian company. In 2018, Y distributed its profit arising before 2018, while X received dividend income in 2018 and included it in the income statement for 2018. In 2019, X plans to distribute its profit for 2018 in dividends.

Section 6(1) of the CIT Act permits a taxpayer to reduce the amount of dividend included in the tax base to the extent he has received dividends from a company that is a CIT payer. What X pays as a dividend is only the part of profit that includes a dividend received from Y earlier, meaning X has not paid CIT on that profit. It may also be the case that X's profit paid in dividends includes both a dividend received earlier and some other income already charged to CIT.

The taxpayer's question

In their ruling request, the taxpayer asked the SRS to explain how PIT should be applied in this situation if –

- the profit out of which Y pays a dividend to X arose before 2018, and
- the profit out of which X pays a dividend to the individual arose after 2017 and represents a dividend that is exempt from CIT at source.

The SRS intepretation

Having assessed the outcome of interaction between the CIT Act and the PIT Act, the SRS says X is permitted to exempt PIT on a dividend it pays to the individual out of X's profit arising in 2018. This is also true if X has deducted a dividend paid by another company from the amount of dividend to be included in X's tax base under the CIT Act, which is the reason why CIT on the dividend received by the individual has not been paid or has been paid in part.

PwC comment

In making this finding, the SRS says paying dividends through a chain of companies may ease the PIT burden on the beneficial owner of that chain. And this may be done without using any complex cross-border arrangements – a two-tier group structure in Latvia does the job perfectly. For example, if Y has accumulated a profit for 2017 that is payable to the individual and attracts a 10% PIT only in 2019 and a 20% PIT in 2020, then inserting another Latvian company, X, between Y and the individual may achieve a 0% PIT.

And the SRS does not mention the need to evaluate the rationale and economic substance of creating the chain of companies to claim the exemption under the PIT Act. However, section 9(3.8) of the Act provides that the exemption on dividends received is not available if the arrangement is found to have been created artificially. One of the criteria for an artificial arrangement is the fact that a dividend paid directly from its ultimate source would attract a higher rate of PIT than what is due on the same dividend paid through an arrangement or a series of arrangements.

This finding is closely linked to our comment on the ruling of 4 January 2019.

In these rulings, the SRS ignores the criteria for evaluating the economic substance, which assures the ruling recipient that the purpose of making the transaction or creating the arrangement will not be evaluated on a tax audit either.

And by publishing the ruling, the SRS assures us that this interpretation will be applicable in other similar cases, thereby building a practice of applying new legislation, unfortunately without assessing the transaction or payment according to its economic substance.

[1] SRS ruling No. 30.1-8.7/317762 of 18 December 2018