Company liquidation is governed by Commercial Code but tax laws also come into play (3/24/20)

Thousands of companies go out of business in Latvia each year. If a company's shareholders no longer wish to stay in business, they can decide to wind the company up. In certain circumstances, liquidating a company results in its shareholders being entitled to surplus assets (a "liquidation quota") creating extra income. This article explores some of the tax implications for a liquidated company's shareholder receiving income from a liquidation quota, which may differ considerably if the shareholder is an individual or an entity.

A liquidation quota

The company being liquidated may have some surplus assets, whether movable or immovable, and funds that are not necessary for paying its creditor claims and liquidation expenses, which the liquidator then returns to the shareholders as a liquidation quota.

The shareholder is an entity

Under section 4(2) of the Corporate Income Tax ("CIT") Act, the taxable base includes a liquidation quota, which is classified as a deemed distribution of profit. Accordingly, the company in liquidation has to charge CIT on the liquidation quota when filing the CIT return for the last month of the financial year (for which the closing balance sheet is drawn up) along with the closing balance sheet and the profit and loss account, and has to pay the CIT charge on or before the 20th day of the month that follows the month in which the extraordinary (closing or liquidation) balance sheet was approved.

Section 6(1) of the CIT Act allows a company to deduct from dividends included in its taxable base any dividend it has received from a subsidiary on which CIT has already been paid. This ensures dividends are taxed only once: when profit is distributed. However, the company cannot deduct from its taxable base a liquidation quota it has received from a subsidiary being liquidated. Accordingly, when the parent company distributes the profit to its shareholders, the taxable income attracting CIT will contain the liquidation quota, which has already been taxed at source.

A different tax treatment applies if the liquidated company's immediate shareholder is an individual.

The shareholder is an individual

Under section 9(1)(2.2) of the Personal Income Tax ("PIT") Act, an individual's annual taxable income does not include a liquidation quota if Latvian CIT has been charged on this income at source or if CIT, PIT or an equivalent tax has been paid on this income abroad. Thus, if the recipient of a liquidation quota is an individual and the Latvian company being liquidated has properly applied CIT, the person will have no further PIT to pay in Latvia. It is important to note that the Latvian company paying the liquidation quota to the individual has to notify the SRS of the payment.

However, if CIT was not charged on the liquidation quota at source, the liquidation quota will form the individual's income attracting PIT under section 8(3)(4) of the PIT Act.

Under section 11.9(1) of the PIT Act, a capital gain arising on the receipt of a liquidation quota under the Commercial Code equals the liquidation quota received less the acquisition cost of the capital asset and any amount invested in it during the holding period. Accordingly, income from the liquidation quota received by the individual is treated as income from capital gains.

In this case, the individual has to file a capital gains tax return in respect of the liquidation quota received and pay PIT at a fixed rate of 20%.

Conclusions and practice

The company has to charge CIT on the liquidation quota it pays to its shareholder, including an individual. The company has to notify the SRS of paying such income to the individual, and in that case the liquidation quota will put no further tax burden on the person in Latvia.

If the process of liquidation has been conducted correctly under the Commercial Code but the Latvian company has failed to charge CIT on the liquidation quota at source by mistake, the individual will have to file a capital gains tax return and pay a 20% PIT on the capital gain, i.e. the liquidation income less their own investment (e.g. the value of share capital).

In practice, however, we have received questions from clients about steps they should take if an asset distribution plan was not drawn up during the liquidation, a liquidation quota was not calculated, and CIT was not charged. Once the liquidation is completed, it is not possible to adjust CIT returns and pay the tax due. If an individual receives income from liquidation in such circumstances, there is a risk that they will find it difficult to report it as income from liquidation and will be unable to deduct their investment from taxable income, and the income will attract progressive PIT rates. To avoid this risk, we recommend that a company’s liquidation be conducted under the direction of lawyers and tax professionals. Our team would be happy to help you, and if you are faced with this issue, please feel free to contact Agate Ziverte, a senior tax manager (agate.ziverte@pwc.com).