

Wider corporate tax exemption on share disposal income 1/16/21



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From 1 January 2022 companies investing in a closed alternative investment fund will be allowed to exclude from their tax base any income the fund earns when selling shares in a company it owns, according to amendments to the Corporate Income Tax ("CIT") Act effective from 20 April 2021. This article explores the rules and how this treatment could affect the fund's investment disposal strategy.

Companies that have put their money in a closed alternative investment fund can earn income from dividends the fund receives from its companies as well as income from a share disposal when the fund decides to sell its investment.

An example

X Ltd, a Latvian-registered private limited company that pays Latvian CIT, acquired certificates of investment in closed alternative investment fund Q in February 2017 and earns income from the fund in April 2021 as a result of the fund selling a 20% stake in Lithuanian-registered company W in 2020. In March 2022, X receives income from the fund selling a further 30% stake in W.

The difference in tax treatment will materialise when X pays dividends to its shareholders. In 2022, when distributing the profit for 2021, X's tax base will include income from the 20% stake in W sold by the fund. When X's profit for 2022 is distributed in dividends in 2023, X will be able to deduct from the dividends included in the tax base the amount received from the fund for the 30% disposal in W.

The rules

To qualify, the fund will have to directly hold shares in W for at least 36 months before their disposal. There is also a requirement that X should be the fund's investor for at least 36 months during the holding period.

The rules leave little room for the fund to change the capital structure of the company shortly before the sale, for instance, by converting loans or bonds into equity. Also, the practice of reorganising and splitting up companies before they are sold to ensure better terms will have to be considered carefully because this relief will not apply to a disposal of shares in a newly formed company as a result of reorganisation.

The rules also prevent the fund from using and setting up a single company for holding multiple investments. If shares are sold by a holding company owned by the fund then its investor will not be eligible for this relief.

The rules certainly put pressure on the funds to devise an initial investment strategy anticipating a potential sale several years later.

In administrative terms the fund's investor will find it fairly easy to claim this relief by obtaining a letter from the fund manager (including a foreign company or manager) stating the holding period for shares

sold by the fund, the investor's participation period in the fund, and the amount of income obtained from the sale.