Is thin capitalisation relevant to banks and insurers? 2/36/21

The Corporate Income Tax (CIT) Act reform effective from 1 January 2018 has brought changes to all aspects of CIT treatment, including thin capitalisation rules. This article explores whether banks and insurance companies should include their excess interest expenses in their CIT base (taxable income).

Thin capitalisation rules

Section 10 of the current CIT Act specifies cases where excessive interest expenses must be included in the CIT base using two methods for measuring the excess. Under one method the CIT base must include any interest paid on a loan that exceeds four times shareholders' equity at the beginning of the tax year (a debt-to-equity ratio of 1:4). The other method applies where interest expenses for the financial year exceed EUR 3 million: the CIT base must include an amount of interest that exceeds 30% of the EBITDA appearing in the profit and loss account for the year.

Exclusions

Section 10(5) of the CIT Act specifies seven exclusions that allow interest expenses to stay out of the CIT base. CIT does not apply on interest paid on the following items:

1. Loans from a credit institution resident in Latvia, in another EU/EEA country, or in a country that has an effective double tax treaty with Latvia;
2. Loans from the Treasury of the Republic of Latvia;
3. Loans from a development finance institution;
4. Loans from the Nordic Investment Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the Council of Europe Development Bank, and the World Bank Group;
5. Loans from an organisation for national financing or crediting or guaranteeing external trade that is resident in a country that has an effective double tax treaty with Latvia or is expressly named in it; and
6. Publicly traded debt securities of Latvia and other EU/EEA countries;
7. Loans for financing a long-term public infrastructure project of national significance in Latvia.

Exclusions before and after the CIT reform

Effective up to 31 December 2017, the old CIT Act made it clear that the thin capitalisation rules did not apply to credit institutions and insurance companies, meaning those companies did not have to identify the provider of finance or measure any excess interest using statutory methods. This exception is no longer available under the new CIT Act.

This raises the question of whether leaving credit institutions and insurance companies off the list of exclusions has been a deliberate step by the lawmaker. Unlike banks, which can probably use one of the other exclusions mentioned in the CIT Act, insurance companies having borrowed from another company within their group should assess whether their excess interest expenses should be included in the CIT base.