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Flow-through dividends: tax pitfalls 1/45/21

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We have already commented on the corporate income tax (CIT) treatment of flow-through dividends and looked at personal income tax (PIT) relief available to an individual receiving a dividend. This article explores potential pitfalls in the tax treatment of flow-through dividends if a change of shareholder takes place shortly before the company decides to distribute a profit.

Background

X Co is a Latvian-registered private limited company that was initially owned by an individual. In early 2021, X Co's owner set up Y Co, another Latvian private limited company, and transferred his X Co shares to Y Co. A few months later, X Co decided to calculate a dividend out of profits earned before 2018 ("old profits"). Y Co then decided to distribute the profit consisting of the dividend it received from X Co.

Tax treatment

When calculating dividends out of old profits, X Co is not required to charge CIT under paragraph 8 of the CIT Act's transitional provisions.

Since Y Co's profit consists of the dividend it received from X Co, section 6(1) of the CIT Act allows Y Co to claim tax relief on this flow-through dividend. Accordingly, dividends included in the CIT base for the tax period can be reduced to the extent the company received dividends in the tax period, hence no CIT in the hands of Y Co.

Since Y Co's owner is an individual, we need to evaluate PIT aspects. When calculating a dividend for the individual, Y Co has no PIT obligations because this move is governed by section 9(1)(2.1) of the PIT Act and by paragraph 35.1 of the Cabinet of Ministers' Rule No. 899. An exemption from PIT is available on dividends if the company paying them was allowed to deduct those dividends from dividends included in the CIT base under the CIT Act. This is a tax treatment the State Revenue Service (SRS) explains in a publicly available tax ruling.

Tax risks

The CIT Act and the PIT Act provide that when it comes to claiming tax relief on flow-through dividends, we need to assess whether there was an intention to avoid taxes. This is an aspect the SRS has also emphasised. If there was such an intention, neither Y Co nor the individual is entitled to tax relief. Section 6(5) of the CIT Act restricts CIT relief on flow-through dividends if there was an intention to obtain an income tax benefit from changing the corporate structure, and section 9(3.8) of the PIT Act restricts PIT relief on dividends. So, if there was an intention to avoid taxes, CIT should be assessed on the flow-through dividend in the hands of Y Co and a 20% PIT should be charged when the dividend is paid to the individual.

The question of whether this case provides a tax advantage would be answered yes, because if X Co distributed its old profits under the original corporate structure, then a 20% PIT would be chargeable under the PIT Act, meaning a higher tax burden.

In summary, there is the risk of the SRS challenging the entitlement to tax relief on the flow-through dividend if they find the new corporate structure to have been artificially created with the intention of obtaining a tax advantage.