

Excess interest charges: corporate tax relief expires in 2022 2/44/22



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To alleviate the consequences of the Covid-19 pandemic, the government has introduced various tax reliefs, including for excess interest charges. This article explores the corporate income tax (CIT) treatment of excess interest charges and what else can be done this year to avoid CIT implications in 2023.

CIT rules

Section 10 of the CIT Act prescribes the CIT treatment of excess interest charges, i.e. non-deductible interest that must be added to the taxable base. The method of CIT treatment depends on the amount of interest.

Interest charges of up to EUR 3 million

Companies with interest charges of up to EUR 3 million in the year of payment must apply the equity method prescribed by section 10(1) of the CIT Act. The taxable base must be increased proportionally by interest whose average liability exceeds four times the shareholders' equity (reserves excluded) at the beginning of the year.

This method does not apply to interest paid on loans from a financial institution that meets the following criteria:

- It's resident in Latvia, in an EU/EEA member state, or in a country that has an effective double tax treaty with Latvia.
- It provides crediting or finance lease services and it's supervised by the supervisory authority for credit institutions or financial services of the relevant country.

Interest charges of over EUR 3 million

In companies with interest charges exceeding EUR 3 million in the year of payment, CIT is due on excess interest computed by two methods:

- Interest paid on loan capital exceeding four times the shareholders' equity (reserves excluded)
- An interest charge that exceeds 30% of the pre-tax profit with interest and depreciation charges added to it

If both methods result in an excess, only the higher amount must be added to the taxable base.

We note that section 10 of the CIT Act prescribes exceptions for loans that are exempt from CIT.

Relief in 2021 and 2022

Section 7.1 of the Covid-19 Act states that taxpayers should not apply section 10(1) of the CIT Act to interest paid during the financial year starting in 2021 and 2022, i.e. the equity method for interest charges of up to EUR 3 million.

Thus, companies with interest charges of up to EUR 3 million could stay unconcerned about CIT implications in 2021 and 2022. However, since there are no plans to extend the relief period, companies still have an opportunity to evaluate and take steps to avoid CIT implications of excess interest charges in 2023.

What else can be done in 2022?

Companies still have the opportunity to assess this year whether they might have any CIT implications of excess interest charges in 2023 if they do not exceed EUR 3 million, and to take all possible steps to avoid those implications.

Increasing share capital

If your company is able to predict now that its average liability for 2023 will exceed four times the equity at the beginning of 2023, its shareholders might consider increasing the share capital. Because the equity at the beginning of the financial year is taken into account, the share capital increase should be completed by the end of 2022 to ensure this does not make your company liable to pay CIT on excess interest charges.

Change the source of financing or make sure the loan is from a financial institution

Since the CIT Act prescribes exceptions for loans from financial institutions in section 10(2) and for certain other borrowings in section 10(5), your company might want to consider changing its financing source to make interest payments eligible for these exceptions.

Companies borrow from various investment funds. We note that an investment fund, too, may be recognised as a financial institution within the meaning of the CIT Act if it meets both of the section 10(2) criteria. Each fund should be assessed on its merits to determine whether it qualifies for exceptions. Based on our experience, we recommend applying to the State Revenue Service for an advance ruling to confirm that a particular investment fund is recognised as a financial institution and your company is entitled to an exception under the CIT Act.

Repaying your loan or converting it into equity

If it's financially possible, your company might repay its loans in 2022 to ensure it has no interest charges in 2023 and no CIT implications to examine. Your loan can also be converted into equity.

In summary, we recommend that companies facing CIT risk around excess interest charges should evaluate their opportunities this year to avoid any CIT liability on interest charges in 2023.