

“Tricks” of loan capitalisation. Things to consider from a corporate tax and transfer pricing perspective 3/9/25



Senior Manager, Transfer Pricing, PwC Latvia
Zane Smutova



Director, Tax, PwC Latvia
Vita Sakne



Consultant, Tax, PwC Latvia
Aleksandrs Afanasjevs

In everyday life, companies have to use an option such as borrowing money for various specific purposes. A significant increase in debt can present the company with challenges that impact balance sheet performance and potential tax risks.

One solution to the problem of increasing debt can be to capitalise the loan – a process whereby the creditor invests its debt rights as a financial asset in the borrower's equity.

This article describes the nature of the loan transaction and its capitalisation with practical examples of possible situations dealing with both corporate income tax (CIT) and transfer pricing (TP) aspects.

Loan transaction

A loan transaction is a transaction in which the lender transfers money to the borrower and the borrower is obliged to return the money to the lender in due course and arrangements.

In order to mitigate the risks associated with the transaction, we provide guidance on the essential aspects to be taken into account by companies when carrying out the loan transaction, in particular between related parties and the TP applied therein.

Aspects of determining the CIT base

- Must ensure that the requirements of Section 10 of the CIT Act are met, in particular the “thin capitalisation” rules which create a CIT liability for increased interest payments if the average annual debt to equity ratio of 4:1 is exceeded;
- if the amount of net interest costs in the reporting year exceeds EUR 3 million, a different method is applied when calculating thin capitalisation, i.e. the amount of net interest is tax-free provided it does not exceed 30% of EBITDA;
- in cases where the result is calculated using both methods, the CIT base will include the least favourable result for the taxpayer.

TP aspects

- Must ensure that the requirements of Section 4, Paragraph two, Clause 2, Sub-clause “e” of the CIT Law are met in relation to the interest rate determined for the loan and its conformity with the market price principle;
- Must ensure that the requirements of Section 11 of the CIT Law are met regarding loans to related parties;
- the CIT return of the 12th month, line 6.5.1, must indicate the total value amount of the controlled financial transaction (CFT) carried out during the reporting year:
 - the loan principal and the interest recognised;
 - or only the loan principal (in the absence of recognised interest);
 - or only recognised interest (if the loan transaction was not concluded in the reporting year).

Capitalisation of the loan

In order to reduce the amount of debt, the borrower may agree with the lender on:

- capitalisation of interest on the loan;

- investing the creditor's claims in the company's share capital.

Below, we will look at practical examples and provide guidance on relevant aspects of the particular situation.

Capitalisation of interest on the loan

The parties to the loan transaction may agree to capitalise the interest by adding it to the loan's principal. This means that the company does not pay that interest but instead calculates further interest on the increased principal.

The capitalisation of **interest on the loan**:

Aspects of determining the CIT base

- does not in itself generate taxable income and does not create a CIT liability;
- may be useful to improve cash flow for example for the company in the short term;
- if the interest payable in the new calculation of interest exceeds the provisions on thin capitalisation, then the aspects of determining the CIT base described above could occur.

TP aspects

- does not constitute a transaction within the meaning of the Civil Law and the commercial Law, therefore it **should not be included in the CFT**;
- must not be reported the CIT return for the 12th month, line 6.5.1.

Capitalisation of the loan

In order to reduce the amount of the debt, the borrower may also agree with the lender to invest the claim rights in the equity capital of the borrower, becoming a shareholder of the company rather than a creditor.

Example

In April 2024, the company A issued its related company B a loan of EUR 100,000 for two years with interest of 5% p.a. in January 2024, B had equity of EUR 20,000 and average debt of EUR 100,000. Under the "thin capitalisation: rules, the company B may incur CIT liabilities because the amount of indebtedness is more than four times the amount of equity. In its December 2024 CIT return, the company reported the additional CIT payable

$$100,000 - (4 \times 20,000) = 20,000 \times 0.25 = 5,000.$$

In order to avoid potential tax consequences also in 2025, the company B decided to propose to increase the share capital by the amount of this loan and to decide for the company A to "transfer" its loan from creditors to an investment in the company B's share capital. Consequently, the estimated amount of the loan increased the share capital of company B in January 2025.

The capitalisation **of the loan**:

Aspects of determining the CIT base

- potential CIT liability for increased interest payments eliminated, but only for subsequent periods starting in January 2025;
- the debt must not be repaid to the company A.

TP aspects

- the parties involved are released from the obligation to comply with TC rules as of January 2025.

A situation may also arise in which the loan is assigned by the lender.

Assignment of the loan

In addition to the contribution in kind (capital injection), the lender may assign or transfer the company's loan to another company, including a related party.

Example: In April 2024, Company A has granted a loan with a term of two years and an interest rate of 5% p.a. to its related party Company B. In December 2024, Company A decides to assign its receivable rights to related party B to another related party C for the carrying amount of November 2024.

The assignment of the loan:

Aspects of determining the CIT base

- there are no restrictions on the transaction;
- however, the question of the amount of "lost debts" may arise if the assignment confers the receivable right for less than the amount of the loan itself.

TP aspects

- is considered to be a transaction within the meaning of the Civil Law and Commercial Law, therefore it should be included in the CFT;
- the requirements of Section 4, Paragraph two, Clause 2, Sub-clause "e" of the CIT Law must be met, as it is important to assess by the successor in title the economic benefit and risks of the transaction;
- total value amount of the controlled financial transaction carried out during the reporting year must be reported on the CIT return of the 12th month, line 6.5.1 :
- amount of the receivable assigned.

Conclusions

The capitalisation of receivables can be an effective means of optimising a company's financial structure and offers solutions to reduce both debt and tax risks. However, in order to fully utilise the benefits of this tool and avoid potential risks, it is important to carefully consider each individual situation.

Companies must prepare all the necessary documents when making the investment of debt in share capital or its assignment in order to ensure transparency and compliance with the legal framework and avoid possible disputes with the State Revenue Service.