

More local companies subject to arm's length principle (1/43/17)

As part of Latvia's tax reform a new Corporate Income Tax (CIT) Act was adopted on 28 July 2017 to govern CIT treatment from 1 January 2018. Under powers delegated by the CIT Act, the Cabinet of Ministers' proposed Regulation for the Application of Provisions of the CIT Act was announced for consideration at the meeting of state secretaries on 12 October 2017, laying down a number of conditions and restrictions on CIT treatment.

This article explores how the term "related party" used in the CIT Act applies when measuring the tax base of local companies and how the draft regulation clarifies this term.

Current CIT Act requirements for local companies

Transactions between related parties are governed by special rules under section 12 of the current CIT Act throughout 2017. However, this clause covers not only transactions between Latvian and foreign taxpayers but also those between two local companies forming a group under section 12(7-10) of the CIT Act.

In other words, the rules for measuring and defending market prices in related-party transactions (known as the arm's length principle) should be observed also in transactions where both parties are Latvian taxpayers if one local company's stake in the other reaches 90%, among other things. So under the current model the arm's length principle applies to related local companies only from a 90% stake - see A's mutual transactions with B in the example below:



New CIT Act requirements for local companies

The new CIT Act effective from 1 January 2018 lays down conditions for measuring the tax base of taxpayers that enter into transactions with related parties.

Section 4(2)(2)(e) of the Act provides that deemed profit distributions should be added to the tax base.

These include any income the taxpayer would have gained or any expense he would not have incurred -

- if his commercial and financial relationships had been based on conditions in place between two independent parties, and
- if the value of transactions between related parties (one of whom is a taxpayer) matched the market price (value) calculated under methods prescribed by the Cabinet of Ministers.

This means that the current special rules for related-party transactions will continue to apply, and the explanation in brackets makes it clear that one of the parties should be a taxpayer.

Changes for local companies subject to the arm's length principle in mutual transactions

There is one crucial change in identifying local companies that will be required to analyse and prove that the price of a controlled transaction is arm's length.

Section 1(1) of the CIT Act provides that the terms used in it match those used in the Taxes and Duties Act. Paragraph 3 of the draft Cabinet Regulation also states that the term "related party" used in the CIT

Act matches the one used in the Taxes and Duties Act.

Section 1(18)(b) of the Taxes and Duties Act gives a fairly wide definition of “related parties” covering also the case of one company having a 20–50% stake in another.

So from next year the arm’s length principle in measuring the tax base of related local companies will apply from a 20% stake instead of the current 90% – see A’s mutual transactions with B, C and D in the example below:



The draft **Cabinet Regulation** is still to be debated and approved by the Cabinet of Ministers. It is possible that the lawmaker will make some amendments relating to this requirement because the rules should be worded as clearly as possible.