

CIT Act to deal with controlled foreign companies (2/37/18)

Latvia is in the process of passing into its national legislation the provisions of the Anti-Tax Avoidance Directive (2016/1164) to achieve its aims of preventing tax base erosion on the internal EU market and profit shifting outside the EU. This article looks at some of the new provisions for controlled foreign companies (CFC) to be inserted in the Latvian Corporate Income Tax (CIT) Act.

Taxing CFC profits

The Ministry of Finance has presented proposals for amending the CIT Act to require that a Latvian company owning a substantial share in a foreign company should pay CIT on profits in proportion to that share if the foreign company is a non-genuine (wholly artificial) arrangement made to obtain a CIT advantage. The proposals make the CFC treatment applicable only to income that is artificially shifted to the foreign subsidiary. The amendments are to come into force on 1 January 2019, with a new section (6.1) to be inserted in the CIT Act. As stated above, this rule aims to prevent a Latvian parent from shifting profits to a subsidiary established in a country where profits attract a lower effective tax rate than the Latvian one, and this rule may extend to jurisdictions that are not even blacklisted as tax havens.

A substantial share in a foreign company means that through direct or indirect participation (including by contract) a Latvian-resident company owns more than 50% of that foreign company or is entitled to more than 50% of its profits. This definition given by the proposals is broad and not restricted to formally registered subsidiaries.

However, the level of participation in non-genuine arrangements is not the only rule. The CFC treatment will also apply to a Latvian company that meets the following criteria for non-genuine arrangements:

- No substantial business is carried on by the CFC or series of arrangements;
- The main purpose of setting up the CFC or series of arrangements is to obtain a CIT advantage. This criterion will be applied by assessing the economic substance (not only the legal form) of transactions and significant decision-making activities that result in income being shifted to the foreign subsidiary.

If these criteria are met, then any profit made by a CFC that is based or incorporated in any of the tax havens blacklisted by the Latvian government will be taxable in Latvia from the first cent, while a CFC registered elsewhere will not attract Latvian CIT unless its profits reach €750,000 and/or passive income exceeds €75,000.

Paying CIT

Taxpayers will have to evaluate their participation in foreign companies on the last day of the financial year. If the Latvian company has a taxable item as a result from applying this rule, that item should be included on the CIT return for the last month of the financial year, after dividing total taxable items by a coefficient of 0.8. To avoid double taxation, the Latvian taxpayer will be allowed to reduce any dividends included in the tax base for the tax period to the extent that dividends were received from the foreign company's profits in the tax period for which CIT was paid earlier.

As you may know, Latvia has already passed some of the rules aimed at helping member states prevent tax evasion. These rules have been inserted in sections 6, 10 and 13 of the new CIT Act.