Tax treatment if owner lends to or borrows from company 2/42/21


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This article explores the corporate income tax (CIT) and personal income tax (PIT) treatment of financial transactions between a Latvian company and its owner (an individual) in two examples:

1. The owner lends to the Latvian company. Our analysis refers to a tax ruling the State Revenue Service (SRS) published on 26 September 2021.
2. The owner borrows from the Latvian company.

The owner lends to the company (based on the situation in the tax ruling)

The company would like to borrow EUR 20,000 from its owner for business purposes for a period of up to three years. The loan agreement provides for 20% annual interest. For practical purposes we assume the loan was disbursed on 28 September and the principal is not repayable until early 2022.

PIT treatment

Under the PIT Act, interest income and deemed interest income is part of the taxable base for the year, but repayment is not treated as taxable income. So the owner will be assessed to a 20% PIT only on interest charges (at source) and not on the principal:

Tax	Item	Calculation
PIT	Repayment of principal EUR 20,000	No PIT
	Monthly interest as per tax ruling request	EUR 333.33
	PIT withholding by company	333.33 x 20% = EUR 66.67
	Gross interest transferred to owner	333.33 – 66.67 = EUR 266.66

PIT must be withheld on the interest at source. The company must report the income on or before the 17th day and must pay tax to the government by the 23rd day of the month following payment of interest.

CIT treatment

Section 10 of the CIT Act prescribes the amount of interest that must be added to the taxable base. In this case the company will be governed by section 10(1), which prescribes the amount of interest to be included in the taxable base in proportion to how far the average liability (on which interest is charged) for the financial year exceeds an amount equal to four times the shareholders' equity appearing in the company's annual report (at the beginning of the financial year) less the revaluation reserve and any reserves other than those resulting from profit distribution.

The CIT base may include interest on a loan from a Latvian-resident individual even though the interest already represents his taxable income for PIT purposes on which PIT is withheld.

In the case of a newly formed company, we take the equity when the company started trading (the opening balance sheet) to arrive at the equity at the beginning of the financial year.

Tax	Item	Calculation
CIT calculation as per SRS example	(1) The average liability, assuming the loan is not repaid in 2021	*28.09.2021 EUR 10,000* *30.09.2021 EUR 20,000* *31.10.2021 EUR 20,000* *30.11.2021 EUR 20,000* *31.12.2021 EUR 10,000* (10,000 x 2 + 3 x 20,000) / 4 = EUR 20,000
	(2) Four times the equity on the opening balance sheet	2,800 x 4 = EUR 11,200
	(3) The ratio of (1) exceeding (2)	20,000 / 11,200 = EUR 1,786
	(4) The estimated interest charge for the year (September–December 2021)	333.33 x 4 = EUR 1,333.32
	(5) The permissible interest charge	1,333.32 / 1,786 = EUR 746.54
	(6) Interest exceeding (5) should be added to the taxable base	1,333.32 – 745.54 = EUR 587.78
	(7) The CIT charge	587.78 / 0.8 x 20% = EUR 146.95

Any interest charge exceeding the prescribed limit must be reported on line 6.3 of the CIT return for the last month of the financial year (e.g. December 2021 if the tax period matches the calendar year).

A further finding from the tax ruling

The SRS points out that there is no double taxation of interest income in this case.

Transfer pricing

A loan between related parties should also be evaluated from a transfer pricing perspective to ensure interest charges are arm’s length. Having assessed the example in the tax ruling we find that 20% interest might be unreasonable and not arm’s length.

The company lends to the owner

PIT treatment

The PIT Act states that if an individual has not repaid a loan within 66 months after it was disbursed, the outstanding loan is treated as income. This must be reported by filing the annual income tax return and using progressive PIT rates.

If the loan is free of interest or if the agreed rate is below market, the person has to calculate income arising from reduced interest. This is calculated as the difference between the relevant amounts, using the annual weighted average interest rate on loans issued to domestic non-financial companies in the previous tax year set by the Bank of Latvia for loans issued in the relevant currency in the previous tax year, multiplied by a coefficient of 0.7 for interest charged under the loan agreement in the tax year.

Below is an example where the owner receives an interest-free loan if the other conditions match the situation described above:

Tax	Item	Calculation

PIT	The average liability, assuming the loan is not repaid in 2021	EUR 20,000 (see calculation in example above)
	The interest rate under the PIT Act	3.01%
	Income arising from reduced interest	20,000 x 3.01% x 0.7 = EUR 421.40
	The PIT charge	421.40 x 20% = EUR 84.28

CIT treatment

If the loan is free of interest, the company is also required to calculate income arising from reduced interest under the CIT Act.