Key aspects of double tax treaties 3/4/22


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Our experience suggests that individuals tend to disagree with tax authorities about how provisions of international law should be applied. There is often disagreement over which country's tax law is applicable and to what extent. A dispute usually arises in the case of a cross-border transaction, i.e. if income is earned abroad. This article explores a few steps that will help you analyse the applicable law and find out whether your foreign-source income is subject to Latvian personal income tax (PIT).

The tax treatment is not solely based on a single national piece of legislation such as the PIT Act. You might also need to look at rules the Cabinet of Ministers has issued to explain the Act, or at Latvia's double tax treaty (DTT) with the country in which your income arises. Latvia has effective DTTs with almost 70 countries.

DDTs aim to eliminate double taxation and fiscal evasion, split taxing rights between the countries, and prevent discrimination. It is important to read the text of a DTT to make sure you apply it properly. At first they may all seem the same, but each can have small yet important differences that may lead to a different tax treatment. We will illustrate this below with an example.

The DTT serves as a tool that, in addition to the national law, indicates each country's rights and duties in taxation, including procedures for exchanging information and granting tax relief. The main objective of a DTT is to eliminate double taxation. This is usually achieved by allowing the person's residence country to apply a tax credit or an exemption if tax is paid abroad.

Analysing tax legislation

Step 1. Determining the country of tax residence

This is often a key aspect of PIT treatment because a Latvian resident pays Latvian PIT on their worldwide income, while a non-Latvian resident pays Latvian PIT on their Latvian-source income only. So Latvia will tax only foreign income earned by a Latvian tax resident.

Step 2. Analysing the national law

Now we need to check if the tax-resident's income is subject to Latvian PIT by assessing the provisions of national law, for instance, the PIT Act. And we need to read the Cabinet of Ministers' explanatory regulations, such as Rule No. 899, Application of Provisions of the PIT Act.

Also, if income has a foreign source, then it is highly likely that the foreign tax authority will also want to tax that income under its national law.

Step 3. Analysing DTTs and other international law

If we find that the tax resident's income is taxable in both Latvia (because none of the national exemptions is available) and the other country, then it is worth analysing the DTT provisions to identify any available exclusions or exemptions. If income is not taxable in Latvia but is taxable in the other country (or vice versa) then in certain cases we can use the DTT provisions to reduce the overall tax burden.

An example based on Latvia’s DTTs with Sweden and Lithuania

Let us now take a look at two seemingly similar DTTs with one key difference that completely changes the tax treatment. We will take article 11, *Interest*, as an example.

Let us start off by looking at Latvia-Sweden article 11(1): “Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.” This means that Latvian-source interest that is paid to a Swedish resident may be taxed in Sweden.

Article 11(2) adds: “However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this limitation.” In other words, interest may attract Latvian tax under Latvian law, but the Latvian tax the beneficial owner has to pay on the interest must not exceed 10%. So, while interest income may be taxed in both Latvia and Sweden, the Latvian rate is capped at 10%.

The DTT then provides for a tax credit (eliminating double taxation) for the Swedish tax resident, i.e. the Latvian PIT paid may be credited against the Swedish tax liability. Since interest income attracts a 20% Latvian PIT, the rate may be reduced to 10% after a Swedish certificate of residence has been obtained and approved.

Now, article 11(1) of Latvia’s DTT with Lithuania states: “Interest arising in a Contracting State and paid to a resident of the other Contracting State, who is the beneficial owner of the interest, shall be taxed only in that other State.” This means that the Latvian-source interest paid to a Lithuanian-resident beneficial owner will be taxed only in Lithuania. To claim this exemption a Lithuanian tax residence certificate must be obtained and approved. In that case the interest income a Latvian company pays to the Lithuanian resident will be free of Latvian PIT. This procedure also works the other way round.

Here is the main difference between the two DTTs. In Sweden’s case, interest may be taxed in both countries, while in Lithuania’s case, tax will be charged only in the country where the person is tax resident.

The takeaway

Only DTTs provide for exclusions or conditions that allow a non-Latvian resident to avoid paying Latvian PIT on certain types of income or to reduce the rate to 10%. The PIT Act does not provide for such exclusions. Based on the PIT Act alone and without examining the relevant provisions of international treaties, the person would be unaware of the rights they can acquire by filing a residence certificate.