Tax treatment of person's income from participation in tax haven companies 2/3/24

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On 17 October 2023 the EU amended its blacklist of uncooperative tax havens that are subject to special taxation procedures. The blacklist now contains 16 jurisdictions, including Antigua and Barbuda, Belize, the Republic of Seychelles, and Russia. As 2023 saw the list being amended several times, there are certain tax aspects that may raise questions, yet national law does not always provide the answers. In this article we take a look at what the Ministry of Finance (MOF) and the State Revenue Service (SRS) think about the tax treatment of a Latvian-resident individual's income from a substantial participation in a foreign company, including dividends from a blacklisted tax haven.

The regulatory framework

To prevent companies from shifting their profits and assets to tax havens and thus evading tax in their country of residence, several countries (including Latvia) have adopted an anti-avoidance tool – rules on controlled foreign companies. From 2013 these rules are part of the Latvian Personal Income Tax (PIT) Act, which lists a number of features to identify a foreign company with a substantial participation.

Section 8(3)(12.2) of the PIT Act states that an individual's income chargeable to PIT includes income from a substantial participation in a foreign company whether or not its profit has been distributed in dividends.

The PIT Act defines a foreign company as a limited company, partnership or other legal entity, foundation, trust or other legal arrangement that is based, formed or established in a tax haven and whose shares are not listed on the regulated market of an EU or EEA country.

A substantial participation means that the taxpayer owns, whether directly or indirectly, at least 25% of the shares or voting power in the foreign company or has, whether by contract or otherwise, a significant influence or the right to share in its profits or asset-value increases. Section 17.3(4) of the PIT Act states that the level of participation is determined on the last day of the year (i.e. 31 December).

So, if a Latvian resident owns a foreign company that meets the PIT Act's criteria, then he must pay Latvian PIT on the part of the company's profit or asset-value increase calculated in proportion to his share in capital, voting power or other rights that give him a significant influence or allows him to share in the profit (asset-value increase).

PIT treatment of profits (asset-value increases) and dividends

Latvian-resident taxpayers must report their income from a substantial participation in a foreign company on the Latvian annual income tax return filed with the SRS, attaching their foreign income return or any other document confirmed by the foreign tax authority where the taxable income and the tax paid can be

identified (the amount of foreign tax does not affect the Latvian PIT calculation, though). When the annual tax return is filed, the taxpayer's income is subject to PIT at progressive rates.

However, the MOF/SRS opinion states that where the foreign income return is the only document of evidence and is filed after 15 March in the following tax year, the Latvian taxpayer is allowed to file the annual tax return within two months after the foreign filing deadline but he must notify the SRS.

When filing the annual tax return, the taxpayer must attach a letter giving details in free form of the foreign company and the level of participation on the last day of the tax year as required by section 17.3(7) of the PIT Act.

The PIT Act states that dividends are not included in the annual taxable income and are not taxed if a foreign corporate tax or similar tax has been paid or a foreign PIT or similar tax has been withheld on those dividends. Yet this rule does not apply to payers of income that are based, formed or established in a blacklisted tax haven. This means that dividend income from a tax-haven company will attract a 20% PIT whether or not foreign tax has been paid.

However, if a dividend is calculated from the profit for the period for which tax has been paid on income from a substantial participation in a foreign company, then this part of the dividend stays out of the resident's taxable income. So, if the foreign company's result for 2023 is a profit chargeable to Latvian PIT as income from a substantial participation in a foreign company on the income tax return for 2023, but it's decided in 2024 to distribute a dividend out of this profit, the taxpayer can report this dividend on the income return for 2024 as exempt from PIT after filing documentary evidence of the 2023 profit distribution plus a letter of explanation stating that this profit has already been taxed as income from a substantial participation in a foreign company.

PIT treatment of interim dividends

Like income from a substantial participation in a foreign company, interim dividends must be reported in the following tax year through the annual tax return. So interim dividends attract a 20% PIT. When determining taxable income from a substantial participation, the taxpayer is allowed to deduct interim dividends from the tax base.

Here it's important to remember that dividend income is treated as derived on the date the resolution is made to declare a dividend. If the resolution was made in the previous tax year but the dividend was paid in the current tax year, this will have to be reported on the annual tax return for the previous tax year, so the 2023 changes to the blacklist may have no tax implications in certain cases. This means the profit calculation for 2023 does not affect the calculation of dividend from the profit for 2022 regardless of when it was paid. When determining the tax base for income from a substantial participation in a foreign company for 2023, the taxpayer cannot deduct dividends that were paid in 2023 out of the profit for 2022; only interim dividends are deductible (if any).