Corporate Tax Issues in the Baltics

In the last twenty years the Baltic States has gone through many historical changes. The changes have affected the political system, society, economics, capital market as well as taxation system. In order to improve global competitiveness Lithuania, Latvia and Estonia has made a remarkable development towards its tax systems.

Since 1st May 2004 the Baltic States are European Union Member States. This has also affected the taxation systems of all three states. It shall be noted that there are many similarities between corporate tax systems of all three Baltic States but at the same time there exists also some significant differences.

Latvia

Generally

In Latvia after the collapse of the Soviet Union the first law regarding corporate taxation "On Profit Tax" was adopted on 20th December 1990. However, after five years on 9th February 1995 the new law "On Corporate Income Tax" was adopted and the law "On Profit Tax" was cancelled. The law "On Corporate Income Tax" undergoing many amendments is still effective and establishes the main principles of corporate taxation.

Taxable persons

Corporate income tax applies to companies-residents for taxation purposes in Latvia as well as to non-residents. Resident companies are taxable on their worldwide income, but non-resident companies are subject to corporate income tax only regarding Latvian source income. Non-resident companies operating through a permanent establishment in Latvia are subject for taxation for revenue gained by that permanent establishment, as well as revenue independently obtained abroad by the permanent establishment.

If a non-resident company engages directly in business activities that are similar to the business activities performed by its permanent establishment in Latvia, income derived from the non-resident company's activities is included in the taxable income of the permanent establishment. A company is considered to be resident in Latvia if it is established, registered, or is required to be established and registered, in accordance with Latvian law.

Taxable period

The taxable period is the tax year, which generally corresponds to a calendar year. Companies must pay tax advance instalments by the 15th day of each month. In general, for the period from the first month of the taxation period up to and including the month that the annual report is filed, but not later than four months after the taxation year ends, monthly advance instalments are equal to 1/12th of the annual tax calculated for the tax year 2 years prior to the current tax year, adjusted for inflation.

For the remaining months, the monthly advance payments are each equal to the tax paid for the preceding tax year, adjusted for inflation for the preceding tax year and reduced by the advance tax payments made in accordance with the above-mentioned procedure, divided by the number of months remaining in the respective year.

Any outstanding tax must be paid within 15 days of the due date for the annual corporate income tax return. The tax return generally shall be submitted no later than 4 months after the end of a tax year i.e., till 30 April.

Losses

Since 1st January 2009 losses may be carried forward for 8 years (previously 5 years) in the order in which they are incurred. It shall be noted that Latvia is one of those EU Member States which provides for group relief of losses which applies not only to resident companies but also to the foreign companies that are residents in states with which Latvia has a double tax treaty, and to companies that are residents in other European Economic Area Member States (Iceland, Lichtenstein and Norway). Thus there is no discrimination between residents and non-residents.

Tax rates

Since 1st January 2004 the corporate income tax rate in Latvia has been 15 percent which is one of the lowest corporate income tax rates within the European Union. Till 1st January 2002 the corporate income tax rate was at 25 percent but then the government decided to reduce it gradually and thus make Latvia more attractive to foreign investments.

Generally a company`s taxable period is 12 months. The taxable period corresponds to the calendar year, but company may elect to have a taxable period different from the calendar year.

In respect of payments made to non-residents the withholding tax applies at the following rates:

- Consulting fee – 10%;
- Dividends – 10%;
- Interest to related party – 5% or 10%;
- Interest by Latvian bank to related party – 15%;
- Royalty – 5/15%;
- Use of property fee – 5%.

The taxable period is the tax year, which generally corresponds to a calendar year.

However, in some cases exemption applies, for example, exemption settled in a tax treaty.

In case the payment is made to-non-resident situated in a low tax or non-tax states or territories the withholding tax at 15% rate applies.

It shall be noted that there is no tax on dividends paid between companies that are residents in Latvia as well as to dividends which are paid out to/received by the company which is resident for tax purposes in another European Union Member State or in a European Economic Area member state. However, those EU/EEA companies, besides being residents for tax purposes in the respective member states, should also comply with other criteria such as having one of the legal forms of the companies mentioned in the annex of EU Parent Subsidiary directive. They should also be payers of corporate income tax in their respective states.

In case dividends are paid to non-residents situated in other countries than mentioned-above the withholding tax settled in the law or in a tax treaty applies. As regards the dividends received from other foreign countries such dividends are not taxable in Latvia if they are paid out of the company in which Latvian company in the moment of payment the dividends holds at least 25 percents of voting rights and capital rights and the company paying the dividends is not situated in low tax or no tax states or territory. Thus it may be concluded that Latvia has quite favourable dividend taxation system.

Special tax regime

A special tax regime applies to resident shipping companies in regard to their income from the operation of ships in international traffic. The taxable income under such tax regime is calculated by multiplying the net tonnage of each qualifying ship by the number of days in tax year during which the ship was used like international transport or related activities and a coefficient ranging from 0.022 to 0.0007 which is determined accordingly to the ship`s tonnage.

Transfer pricing

The transfer pricing issues among other tax issues are regulated in the law "On Corporate Income Tax" and in the Regulations regarding the application of the law "On Corporate Income Tax". It shall be noted that comparing to other EU Member States as well as to OECD Member States the transfer pricing issues in Latvia are not so developed.

Transactions between associated companies shall be adjusted if the transactions are made at price below fair market price or at above fair market price.

Two or more companies will be considered to be associated if:

1) those companies are a parent and a subsidiary;

2) one company has a participation of 20 percent till 50 percent in the other company without having a majority of the voting power;

3) in few cases when the control is exercised by the common ownership by an individual and his/her close relatives;

4) there are any contractual relationships between the companies regarding any additional remuneration which is to be paid outside the contractual relationships or those companies are making any other concerted action in order to decrease the payable taxes.

For the transfer pricing adjustments there are used the following methods: cost plus method, comparable price method, resale method. If those traditional methods are not appropriate it is allowed to use such additional profit methods:

net profit method and profit dividing method. For the application of the methods it is allowed to use OECD Transfer Pricing Guidelines.

Double taxation relief

Double taxation of foreign income may be prevented unilaterally by the credit method settled in the law or by method settled in the respective tax treaty. Almost all tax treaties concluded by Latvia contains credit method, except, for example, the tax treaty with Lithuania in which the exemption method is established.

According to the credit method corporate income tax calculated and payable in Latvia may be reduced by the amount of corporate income tax paid in foreign countries. However, such deduction shall not exceed that part of the income tax in Latvia, as computed before the deduction is given, which is attributable to the income which have been taxed abroad.

In case where the tax treaty is applied, double taxation relief method settled in the tax treaty applies, unless the credit method settled in the law is more beneficial.

Tax treaties

In regard to the tax treaties it shall be noted that Latvia together with other Baltic States began its work for conclusion of tax treaties already in 1992. Latvia`s tax treaty model is based on the OECD Model Convention and the UN Model Convention.

Till now Latvia has held negotiations with 60 states, initialled tax treaties with 58 states, and from which 49 conventions are signed and 48 conventions are applied. Latvia has tax treaties with almost all EU Member States, except with Cyprus.

The first tax treaties were concluded with Sweden, Finland, Denmark and Norway which are applicable from 1st January 1994. The tax treaties with Canada and the United Stated are applicable accordingly since 1st January 1996 and 1st January 2000. Latvia still does not have tax treaties with such states as Japan and Australia but it is awaited that in the nearest future the tax treaties with India, Morocco and South Korea will come into force.

As regards withholding taxes established by the tax treaties it shall be noted that in respect to dividends mainly divided rates are settled in the tax treaties. Accordingly 5/10 or 5/15 where the lowest rate is applied in case of participation where the holding or voting power is at least 25%, in some cases 10%, but the highest rate is applied in all other cases. However, unified rate to all kind of dividends at 10% rate is settled in the tax treaties with Belarus, Moldova, Portugal, Romania, Slovakia, Turkey, and Uzbekistan. As regards the United States and Canada then five percent rate is applied in case of the United Sates if the beneficial owner is a company which holds directly at least 10 percent of the voting shares of the company paying the dividends but in case of Canada to dividends paid by a non-resident-owned investment corporation that is a resident of Canada, if the beneficial owner is a company which controls directly at least 25 per cent of the voting power in the company paying the dividends. In all other cases the 15% rate will be applied both the United States and Canada.

In respect of interest payments mainly the withholding rate is settled at 10% rate, however, in case of Bulgaria and Macedonia it is reduced to 5%, but in case of Israel there is settled 5% rate in respect of interest on bank loans but 10% rate in all other cases. However, many treaties grant an exemption for certain kind of interest; for example, interest paid the central bank, to the state and local authorities etc.

Finally in respect of royalties mainly divided rate 5/10 is settled in the tax treaties. However, in some treaties unified rate at 10% is applied, but in case of Israel 5% rate, but in case of Singapore 7,5% rate. As regards the United States the divided rate is applied. Five percent rate in case the royalties paid for the use of industrial, commercial or scientific equipment and ten percent in all other cases.

It shall be noted that in the treaty with Lithuania rate at 0% is settled in respect of interest payments and royalties.

Many changes on tax system in Lithuania have been introduced as of January 1st, 2009.

Lithuania

Generally

In the middle of 1990s Lithuania determined 33 percent of flat tax rate, which even being the highest among other Baltic states (Estonia implemented a 26 percent rate and Latvia - 25) significantly improved economic growth in Lithuania. Free economy market and economic development has led Baltic States to decrease their flat tax rates in order to become more attractive to foreign investors, therefore Lithuania has not been an exception. Due to this, the flat income tax rate in Lithuania was lowered to 24% in 2008 and from 2009 is at the rate of 15%. Furthermore, minimum wage in Lithuania is 310 USD, average - 820 USD.

Many changes on tax system in Lithuania have been introduced as of January 1st, 2009. State and municipal budget proposals as well as Crisis Management Plan deeply influenced current tax system. The amendments, which are already in force, are believed to ensure stability in public finances.

Taxable persons

In Lithuania as in Latvia the corporate income tax payers are companies-residents for taxation purposes in Lithuania on their worldwide income, but companies-non-residents are taxed in respect their Lithuanian source income. All kind of companies registered under Lithuanian law are deemed to be residents for taxation purposes in Lithuania.

Taxable period

The taxable period is the year which also as in case in Latvia corresponds generally to a calendar year. However, the date of submission the annual corporate income tax return differs. In Lithuania the annual tax return shall be submitted by the first day of the 10th month of the following year which is 1st October. It shall be noted that if the company is paying or receiving dividends the tax return for dividends shall be submitted to the tax authority by the 10th day of the month during which the dividends have been received or paid. In case if any withholding taxes from payments to non-residents have been made the return shall be submitted within 15 days after the month during which the payment was made.

Tax rates

From 1st January 2009 corporate income tax has increased from 15% to 20%. Wherewith, the corporate income tax rate in Lithuania is 5% higher than in Latvia. However, together with the rate increase it is also provided that 50% of reinvested profits will not be taxable. It means that the companies will be allowed to invest non-taxed profit into long-term assets for production of new products or services, increase of capacity, implementation of new processes and technologies.

As regards tax on dividends it shall be noted that from the 1st January 2009 tax on dividends is settled at 20% rate. Previously the rate at 15% was applied. Moreover certain tax exemptions are also restricted. Previously there was no tax on dividends when the shareholder has been controlling more than 10% in the company for more than 12 months. Now the exemption will not be applied to dividends received from companies that have enjoyed 0% rate on profits or other corporate income tax relief.

The withholding tax rates also have experienced changes. Previously the withholding tax rate to different payments to non-residents was 10% but as of 1st January 2009 the withholding tax rate increased from 10% to 20% rate. The withholding tax is applied to such payments to non-residents: income from the sale or lease of immovable property located in Lithuania, dividends and other income from distributed profits etc. However the withholding tax at 10% rate will be applied as previously on compensations for violation of copyright or related rights, royalties and interest payments.

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Transfer pricing

In Lithuania transfer pricing issues are laid down in the laws and fully applied in practice. It is settled that an open market value corresponds to the amount of consideration which a purchaser would have to pay for the goods or services to a supplier thereof at arm's length where each one of them is seeking maximum economic benefit for himself.

The associated persons include individuals and companies who qualify for the following criteria:

1) they are related parties, for example, shareholders, members of the management bodies, spouses and other relatives, group companies (25 percent participation) and their shareholders etc.;

2) in case they are able to influence each other and therefore transactions between them may differs from those which would be included between unrelated persons who are seeking for economic benefit.

In the cases where the tax administrator has grounds to suspect that the taxable amount of the supplied good or service has been artificially increased or reduced, it will have the right to calculate the taxable amount. The taxable amount of the supplied good or service may be considered artificially reduced or increased in the case where upon giving due consideration to all conditions of the transaction the taxable amount does not correspond to the open market value of the good or service (it has been fixed having regard to an individual purchaser - related person, etc.). The taxable amount is calculated, on the decision of the tax administrator, on the basis of the open market value determined in accordance with the methods approved by the Government of the Republic of Lithuania or an institution authorised by it. The methods applied are: comparable uncontrolled price method, resale price method and the cost-plus method. In some case it is allowed to use the profit split method and the transaction net margin method. The OECD Transfer Pricing Guidelines may be used for application of the transfer pricing guidelines.

The transfer pricing requirements are applied resident companies, permanent establishments of the non-resident companies, financial and credit institutions, insurance companies.

The transfer pricing is not applicable to the supply of goods or services performed for a consideration fixed by state or municipal institutions and agencies or in the international agreements of the Republic of Lithuania.

Double tax relief

Generally the credit method is used as a unilateral method for double tax relief. It means that companies-residents may set off any foreign tax against their Lithuanian corporate income tax liability on the same income. However, the credit may not exceed the Lithuanian tax liability.

It shall be noted that the credit method for double tax relief does not apply to dividends received from abroad. Wherewith, such dividends are subject to double taxation, unless the tax treaty or the participation exemption applies.

As regards interest payments received from abroad, the special treatment applies. If such interest payment forms less than 25% of the total income of the recipient company, the amount of foreign tax credit is limited to one fifth of the total corporate income tax liability calculated under

domestic tax rules.
In Lithuania likewise in Latvia in case where the tax treaty is applied, double taxation relief method settled in the tax treaty applies, unless the credit method settled in the law is more beneficial.

Tax treaties

Currently Lithuania has signed 46 tax treaties. The treaties are drowned to the Lithuanian tax treaty model, which is based on OECD and United Nations Model tax conventions. International treaties enjoy supremacy over national Lithuanian laws unless the national law is more beneficial.

One of the first tax treaties came into effect with Sweden, Finland, Denmark and Norway in 1994, with Poland, Germany and Latvia in 1995, with Czech Republic in 1996. Few of the most recent tax treaties are in effect since 2009 with Macedonia, since 2008 with Korea, since 2007 with Israel, Bulgaria and Luxemburg.

Lithuania has concluded tax treaties also with Canada and the United States of America. Tax treaty with Canada was signed on 29th August, 1996 and is applicable from 1st January 1998. Where the tax treaty with the United States of America was signed in Washington on 15th January 1998 but is applicable from 1st January 2000.

In accordance to the tax treaties tax on dividends, interest and royalty are more favourable.

Tax rate on dividends with a regard to various tax treaties slightly varies. Tax rate on dividends is divided to several groups: when recipient owns more than 25% of the payer's share capital, accordingly 20% and 10 % of the payer's share capital. There are only two tax treaties – with Estonia and Switzerland wherewith tax rate on dividends is 5% when recipient owns more than 20 of the payer's share capital. With Bulgaria and Macedonia 0% tax rate on dividends is applied when recipient owns more than 10% of the payer's share capital. As well with Latvia 0 % rate is applicable in the cases where the recipient owns more than 25% of the payer's share capital. However these examples are more exception then the rule. Generally the tax rates varies from 10 to 15% with an exceptions of 5% tax rate on dividends when the recipient owns more than 25%, 20% or 10% of the payer's share capital (f.e. Armenia, Austria, Belgium, Greece Spain, Italy, Netherlands etc.).

With a regard to the tax treaty between the United States and Lithuania the tax on dividends cannot exceed 5% when the recipient owns more than 10 % of the payer's share capital and 15% of the gross amount of the dividends in all other cases. In comparison in the tax treaty with Canada the tax on dividends cannot exceed 5% when the recipient owns more than 25 % of the payer's share capital and 15% of the gross amount of the dividends in all other cases.

Tax rate on interest in the tax treaties with Lithuania is at the rate of 10%. With a regard to the tax treaty between Lithuania and the United States as well as Lithuania and Canada the tax charged cannot exceed 10% of the gross amount of the interest. The 10% tax rate is applied in both tax treaties and is most common tax rate in the other tax treaties. The only exception is the tax treaty with Latvia, where the 0 % tax rate on interest is foreseen.

With a regard to the tax treaty between Lithuania and United States, the tax rate is 5 % of the gross amount of the royalties paid for the use of industrial, commercial or scientific equipment and 10 % of the gross amount of the royalties in all other cases. However regarding the tax treaty between Lithuania and Canada there is no exception for the royalties paid for the use of industrial, commercial or scientific equipment and general tax rate of 10 % of the gross amount of the royalties is applied. On the other hand, royalties paid by Lithuanian legal entity to foreign legal entity is taxed at 10 % rate to copyright, know-how, franchise, rent and selling of immovable property and violation of copyright.

Tax rate on dividends with a regard to various tax treaties slightly varies.

Estonia

Generally

Estonian corporate taxation is regulated in the Estonian Income Tax Act that was first implemented in 1st January 2000. The taxation system in general has been undergoing a lot of changes and amendments during recent years, but the focus and priority aim has constantly been to maintain the favourable corporate income taxation that has been attracting big amount of foreign investors. Namely, Estonia in contrast the majority of countries does not impose any systematically payable corporate tax. Instead the income tax is charged on distribution of profits as dividends or any other profit in monetary or non-monetary form upon their payment.

Taxable persons and object of taxation

Corporate income tax can be imposed on resident legal person regarding distributed profit, gifts, donations, costs of entertaining guests, expenses and payments not related to business as well as fringe benefits granted to natural persons. Furthermore the coprorate income tax is applied to non-resident legal person that has derived a taxable income in Estonia or has a registered permanent establishment in Estonia. The legal person is considered a resident if it is established in accordance with Estonian law.

From 1st January 2009 also payments made upon reduction of share capital, redemption of shares and liquidation of a legal person became subject to corporate income tax. That was one of the most significant amendments depriving from the option to be taxed under lower personal income tax.

Taxable period

The period of taxation of non-resident legal person's income from which the deductions allowed pursuant to law have been made is one calendar year. The period of taxation of fringe benefits, distributed profit, gifts, and donations, costs of entertaining guests as well as expenses and payments not related to business regarding resident and non-resident legal persons is one calendar month.

Tax rates

The system of gradual reducing of the corporate tax has been not only been one of the major economic but also political goals on the agenda of current as well as preceding government. Worldwide financial crisis set proceeding with the above mentioned system in present condition in great doubt. Yet the resolution in the end of 2008 was to seize the rate in 2009 but maintain the reducing henceforth. The following tax rates are applied from 1st January 2009 during provided periods of taxation:

- 26,58% (21/0,79) during 2009;
- 25% (20/0,80) during 2010;
- 23,46% (19/0,81) during 2011;
- Beginning from 2012 21,95% (18/0,82).

With regard to payments made to non-residents the tax in the amount of 10% is withheld from royalties paid to a non-resident and payments to a non-resident for services provided in Estonia. The full amount of 21% is withheld from:

- Interest payments;
- Dividends;
- Insurance indemnities;
- Rent from a commercial or residential lease;

Payments to a legal person located in a low tax rate territory for services provided to an Estonian resident.

Worldwide financial crisis set proceeding with the above mentioned system in present condition in great doubt.

Transfer pricing

Transfer pricing legislation is applied with regard to provisions on associated persons, which are defined in the following way:

the persons are companies belonging to one group;

one person owns more than 10% of the share capital, total number of votes or rights to the profits of a legal person;

one person, together with other persons with whom the person is associated , owns more than 50% of the share capital, total number of votes or rights to the profits of a legal person;

more than 50% of the share capital, total number of votes or rights to the profits of legal persons belong to one and the same person

the persons own more than 25% of the share capital, total number of votes or rights to the profits of one and the same legal person.

Estonian income tax sets out the core provision of the transfer pricing in one single paragraph, stating that if the value of a transaction conducted between a resident legal person and a person associated with the resident legal person differs from the value of similar transactions conducted between non-associated persons, the tax administrator may, upon determining the income tax, use the values of transactions applied by non-associated independent persons under similar conditions.

The matter of evaluation of transactions between associated persons has been specified in the Ministry of Finance Regulation No. 53 from the 10th of November 2006, where some additional amendments were introduced from the 1st of January 2007. The Regulation sets out the basic principles of comparing of transactions between associated persons (separating goods, non-material values and services) to standard market value, provides determination grounds for the nature of transactions, strategy and general market conditions. The Regulation sets furthermore out practical documentation requirements as well as references are made to specifics of declaration. It has yet to be observed that the latter requirements are applied only to a certain category of companies

Estonia does not have any periodic corporate taxation and has thus shown less interest to transfer pricing than for example its Scandinavian neighbours. But the question has become more opened during last couple of years, especially with regard to evading of transnational double taxation.

Double tax relief

Under tax treaties and ordinary tax credit method is used for double tax relief. However, in the treaties with Lithuania and the Netherlands the exemption method applies in respect of income other than interest, royalties and non-qualifying dividends. Moreover, under domestic law redistributions of qualifying dividends are exempt from tax irrespective of the provisions of the tax treaties.

Tax treaties

Estonia is a party to a large number of tax treaties to avoid double taxation. It has actively participated in development of facilitated international tax climate. There are currently 43 treaties concluded with several more in different stages of preparation. The tax treaty with Canada has been applied from 1st January 1996 and with the USA from 1st January 2000.

As regards withholding taxes to dividends established by the tax treaties then in respect to dividends mainly divided rates: 5/10 or 5/15 where the lowest rate is applied in case of participation where the holding or voting power is at least 25%, in some cases 10%, but the highest rate is applied in all other cases.

However, unified rate to all kind of dividends at 10% rate is settled in the tax treaties with Belarus, Moldova, Portugal, Romania, Slovakia and Turkey. As regards the United States and Canada then five percent rate is applied in case of the United Sates if the beneficial owner is a company which holds directly at least 10 percent of the voting shares of the company paying the dividends but in case of Canada to dividends paid by a non-resident-owned investment corporation that is a resident of Canada, if the beneficial owner is a company which controls directly at least 25 per cent of the voting power in the company paying the dividends. In all other cases the 15% rate will be applied both case of the United States and Canada.

In respect of interest payments mainly the withholding rate is settle at 10% rate. However, in case of France, Luxembourg, Netherlands, Spain, Switzerland and United Kingdom divided rate 0/10 is applied. The lower rate in case of France, Netherlands, Spain, and the United Kingdom applies to the interest paid to the bank but in case of Switzerland also to interest on government bonds etc. Where in case of Luxembourg the lower rate applies to interest on a loan granted to an Estonian enterprise by a Luxembourg bank. Moreover, many treaties grant an exemption for certain kind of interest; for example, interest paid the central bank, to the state and local authorities etc.

Finally in respect of royalties mainly divided rate 5/10 is settled in the tax treaties. However, in some treaties unified rate at 10% is applied, but in case of Singapore 7,5% rate but 15percent rate in case of Kazakhstan. As regards the United States the divided rate is applied. Five percent rate in case the royalties paid for the use of industrial, commercial or scientific equipment and ten percent in all other cases.

Conclusions

It may be concluded that there are many similarities between corporate tax systems of all three Baltic States but at the same time there exists also some significant differences like tax rates, the time of payment of tax as well as the tax treaty network. Wherewith, there exists a tax competition between all three Baltic States. It means that the potential investors may choose what is more convenient for their interests.