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PRACTITIONERS' CORNER

Thin Capitalization Rules in Lithuania

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In Lithuania, parties to various transactions are expected to use transfer pricing principles. The government has also introduced thin capitalization rules, detailing when and how much interest can be deducted.

The rules of transfer pricing and thin capitalization, which were introduced in the Law on Corporate Income Tax as of December 20, 2001 (amendments of February 19, 2009), and Governmental Resolution No. 1575 as of December 9, 2003, are summarized below.

Market Value and Economic Benefit

What Is Market Value?

Transfer pricing in Lithuania is defined in the VAT law and the corporate tax law. Therefore, market value is defined as the amount of consideration that a purchaser would have to pay for goods or services to a supplier at arm's length when each party is seeking the maximum economic benefit for himself.

When the tax administration has grounds to suspect that the taxable amount of the supplied good or service has been artificially changed, it has the right to calculate the taxable amount. The taxable amount of the supplied good or service may be considered artificially reduced or increased when, upon giving due consideration to all conditions of the transaction, the taxable amount does not correspond to the market value of the good or service.

The tax administration calculates the taxable amount based on the open market value determined in accordance with the methods approved by the government or an institution authorized by it. It is not applicable to the supply of goods or services in which consideration has been fixed by state or municipal institutions and agencies or in Lithuania's international agreements.

The corporate tax law defines ''market price,'' which is considered to be the amount for which assets may be exchanged or mutual obligations settled between willing independent buyers or sellers in a direct transaction.

Transaction Adjustments and Revaluations

Entities must recognize as income an amount equal to the actual market value of a transaction or economic operation, and must also recognize the total amount of costs incurred during a transaction or economic operation equal to the actual market price as allowable deductions or limited allowable deductions.

When the conditions created or prescribed by mutual transactions or economic operations between associated persons are other than those created or prescribed by a mutual transaction or economic operation between nonassociated persons, any profit (income) that would be attributed, if no such conditions existed, to one of such persons but is not attributed to him, may be included in the income of that person and taxed accordingly.

Thin Capitalization Rules

All transactions in Lithuania should be based on market value.

The Rules for the Requalification of Income or Payments approved by the government define when income or payments must be requalified.

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Laws prescribe that the share of capital lent for remuneration to a Lithuanian entity by the controlling lender(s), which is in excess of the 4-1 ratio between such lent capital for remuneration and fixed capital, is qualified as ''controlled lent capital.''

The ratio between lent capital for remuneration and fixed capital set above is calculated as of the last day of the taxable period of the Lithuanian entity.

If lent capital is denominated in foreign currency, the ratio between such lent capital and fixed capital is calculated after conversion to litas by applying the official currency exchange rate announced by the Bank of Lithuania as of the last day of the taxable period.

Interest payable on the use of controlled lent capital will be considered unrelated to the earning of income and will not be deductible — for the purpose of calculating taxable profit of the controlled Lithuanian entity — from income of the Lithuanian entity. Currency exchange losses related to controlled lent capital are not deductible from the income of the Lithuanian entity.

The above rule will not be applied if the Lithuanian entity proves that an equivalent loan might be taken on the same conditions between independent (unrelated) persons. Such proof is normally presented according to the Lithuanian Bank statistical data, providing interest rates and its market value of every month. The provisions of those rules will not apply to financial institutions providing financial leasing services.

For example, say that a company's fixed capital is €150, and €700 is the loan from the controlling company that is being unpaid. If the 4-1 principle is applied, then 150 x 4 = 600 — this is the sum to which the company may attribute interest. This interest enjoys the right of possible deductions.

Further, the loan (700) minus the sum to which the company may attribute interest (600) equals 100 — this is the sum from which the interest will be nondeductible.

According to local legislation, fixed capital is defined as the equity of a Lithuanian taxable entity as of the last day of the taxable period, excluding the financial result (profit/loss) of the taxable period concerned. For the purpose of calculating fixed capital, equity of the Lithuanian entity will not include the revaluation result of assets transferred to it by the controlling lender, if such assets have been used by that Lithuanian entity for less than two years.

The following items are unrelated to the earning of income and are not considered deductible for the purposes of calculating the taxable profit of the controlled Lithuanian entity:

- interest payments related to profit, income, or similar performance indicators of the Lithuanian entity;
- interest payable under debt claims entitling the lender to exchange its right to interest with the right to the borrower's profit or a part thereof; and
- rent payments related to profit, income, or similar performance indicators of the Lithuanian entity. ◆

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