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Corporate Tax Issues in the Baltic's

Official Office opening in Vilnius, Lithuania

Please, be informed
that Tallinn's office now
has new location:
**Narva mnt 5,
10117 Tallinn,
Estonia**

We are glad to announce that we have opened a new Gencs Valters Law Firm office in Vilnius, Lithuania. Official opening of the office was held in Radisson Astoria on 6th March, 2009 engaged representatives and members of all the Chambers of Commerce in Lithuania and top-business representatives from all around the globe. The evening started with presentation of the firm's activities which currently has 15 lawyers and tax advisers in the

Baltics. The expansion in the Baltics was completed by opening Vilnius office several months ago. Entertained by magic theatre "Diarchy" and well-known "Saules Kliosas" blues, the opening went to the one of the most successful events of the year 2009, gathering almost 200 guests. Led by the memorizable networking and warm atmosphere Gencs Valters Law Firm's grand opening in Vilnius definitely set first firm steps in Lithuanian market.



Corporate Tax Issues in the Baltic's

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

Since 1st May 2004, the Baltic States are European Union Member States. EU membership has affected the taxation systems of all three states. 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

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

Taxable persons

Corporate income tax applies to companies that are 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, it is registered, or is required to be established and registered in accordance with Latvian law.

Taxable period

The taxable period in Latvia 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 should be submitted no later than 4 months after the end of a tax year i.e., until 30 April.

Losses

Since 1st January 2009 losses may be carried forward for 8 years (previously 5 years). These losses are taken into account in the order in which they are incurred. Latvia is one of those EU Member States that provides for group relief of losses. These group relief provisions 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. Until 1st January 2002 the corporate income tax rate was at 25 percent. Then the government decided to reduce the tax rate 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 – 10%;
- Interest by Latvian bank to related party – 15%;
- Royalty – 5/15%;
- Use of property fee – 5%.

An exemption applies in some cases. For example, a tax treaty may determine the exemption.

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.

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 above mentioned, the withholding tax established 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 time 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.

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". In 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 should 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 the following methods apply: cost plus method, comparable price method, resale method. If those traditional methods are not appropriate, it is allowed to use the following 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 determined in the law or by method determined 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 determined in the law is more beneficial.

Tax treaties

Latvia together with other Baltic States began its work for concluding tax treaties in 1992. Latvia's tax treaty model is based on the OECD Model Convention and the UN Model Convention.

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

Lithuania

In the middle of 1990s, Lithuania established a 33 percent of flat tax rate. That rate while being the highest among other Baltic states (Estonia implemented a 26 percent rate and Latvia – 25 per cent rate) 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 to the rate of 15%. Furthermore, minimum wage in Lithuania is 310 USD, the average wage rate in Lithuania is – 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 taxpayers are companies-residents for taxation purposes in Lithuania imposed 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, this 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. 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 that any withholding taxes from payments to non-residents have been made, the return must 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, from the 1st January 2009 tax on dividends is set 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%. 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.

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 that 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 itself.

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 the parties 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, the tax administrator 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. (The taxable amount applies 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. The credit method for double tax relief does not apply to dividends received from abroad. 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 follow 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.



Estonia

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 large numbers 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 corporate 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.

Transfer pricing

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

- 1) the persons are companies belonging to one group;
- 2) one person owns more than 10% of the share capital, total number of votes or rights to the profits of a legal person;

- 3) 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;
- 4) 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
- 5) 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.

Conclusions

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. There exists a tax competition between all three Baltic States. The potential investors may choose what is more convenient for their interests.

“Expatriate Tax planning 2009” in Vilnius

Valters Gencs law firm in Vilnius, represented by Head of Valters Gencs law firm in Lithuania Dovilė

Preiksaitė held a seminar on Expatriate Tax Planning in Jonas Mekas Visual Arts Center. Pan-Baltic and internationally recognized Gencs Valters law firm continues series of seminars organized in all three Baltic States. The seminar in Vilnius was followed by exposition of best art pieces of internationally recognized Lithuanian painters – Vilmantas Marcinkevičius, Vytautas Tomaševičius, Algis Griškevičius and Audrius Gražys. The guests of the seminar had the exclusive opportunity to meet artists themselves. This initiative is aimed to gather Lithuanian best known painters and their works, discuss investment possibilities in Art and open debate on legal and business matters between diverse professionals. This year our special guests – Member of Parliament Mr. Artūras Zuokas, Chairman of Swedish Chamber of Commerce in Lithuania Mr. Carl Berneheim and Ms. Ilma Nausėdaite Manager of the First International Contemporary Art Fair in Baltic States ART VILNIUS'09.

“Expatriate Tax planning 2009” in Tallinn

On the 19th of March Gencs Valters Law Firm Estonian office hosted a legal seminar in co-operation with German-Baltic Chamber of Commerce. Tallinn office manager Jevgeni Robakov chose to present an interesting and at the same time relatively controversial topic of European Company to the mixed audience of businessmen and legal experts.

Mr. Robakov visualized his audience the historical development as well as the advantages of the Societas Europaea by using various examples of and comparisons to established European Companies in Germany, Finland and Sweden.

see slides at www.gencs.eu/resource/show/18



“Expatriate Tax planning 2009” in Riga

see slides at www.gencs.eu/resource/show/18



**7th annual seminar
„Expatriate Tax Planning 2009”**
was held in Reval Hotel Ridzene,
Kronvalda room in March 11.

Participating Dovile Preiksaite
(Lithuania’s Office representative)
and Jevgeni Robakov (Estonia’s
office representative).



Three Countries.
One Firm.

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