

Taxation and Investment in Latvia 2011

Reach, relevance and reliability



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1.0 Investment climate

1.1 Business environment

Latvia is a parliamentary democracy. Deputies are elected to the *Saeima* (unicameral parliament) under a system of proportional representation. The highest executive power lies with the Cabinet of Ministers, which is led by the Prime Minister. The role and functions of the executive power are stipulated in the *Satversme* (Constitution) of the Republic of Latvia.

The Ministry of Economics is responsible for implementing Latvia's foreign trade policy with the EU, the World Trade Organization (WTO) and other international organizations. The Ministry is in charge of executing the export promotion policy, enforcing the internal market protection policy and fostering economic cooperation with other countries.

Latvia became an EU member state in 2004. Consequently, the business environment is governed by EU legislation, as well as Latvian domestic legislation and various international agreements. No restrictions generally are imposed on foreign entities or individuals with respect to their business activities, although a license may be required.

As an EU member state, Latvia is bound by all trade agreements introduced by the European Union. Latvia's membership in the WTO also entails certain obligations towards an open and well-functioning trade system. Internal EU trade currently constitutes approximately 75% of Latvia's foreign trade. Trade with third countries has undergone some significant changes, including:

- Introduction of the common EU external customs tariff;
- Expansion of the external market as a result of the many free trade agreements concluded by the EU;
- Introduction of quantitative restrictions (quota) for imports of certain goods; and
- Application of EU market safeguards with respect to imports of certain goods.

Recent important structural reforms and budget planning carried out together with the IMF and EC have contributed to the stabilization of the Latvian economy. Currently, a transition to a sustainable economic model is in process where export growth is expected to be the key driver. Aided by its advantageous geographical location on the east coast of the Baltic Sea, Latvia has always been an important transit hub for east-west trade and the new export-led economic model is expected to reinforce this role. Major exports include wood and wood products, machinery and equipment, metals, textiles and foodstuffs, while important imports include machinery, equipment, chemicals and fuels.

Price controls

Companies are generally free to set the prices of goods they sell, provided that the Competition Law is not violated. This law prohibits the dominant market participant from establishing unfair purchase or sales prices or otherwise engaging in unfair trading practices.

Prices are controlled in the public utility sector such as electricity, gas, heat supply, telecommunications, water supply, sewerage and railway. Local municipalities are also authorized to regulate the provision of services in certain sectors, such as municipal waste management, water supply and sewage.

Intellectual property

The protection of intellectual property in Latvia rests upon laws that are based on the legislation of EU Member States and international conventions. Several state and non-governmental organizations are involved in the administration, protection and enforcement of intellectual property

rights, such as the Patent Office, the collective Copyright and Communication Consulting Agency/Latvian Copyright Agency, the Performers' and Phonogram Producers' Society and the Latvian Music Producers' Association.

Authors' rights are generally protected under the Copyright Law. A copyright is in effect for the entire lifetime of the author and 70 years thereafter. A copyright belongs to the author as soon as the work is created, regardless of whether it has been completed. No registration, special documentation or other formalities are required to prove the ownership of a copyright. Copyrights of works that have been edited or otherwise made known in a foreign state, in any material form, are recognized for foreigners in accordance with international agreements binding upon Latvia.

If an author has created a work while carrying out his duties in an employment relationship, the economic rights of the author may be transferred, in accordance with the employment contract, to the employer. If an employee creates a computer program while on a work assignment, all economic rights to the program belong to the employer, unless otherwise specified in the employment contract.

To obtain the right to use a work, the user of the work must obtain permission from the holder of the copyright. The permission can be issued as a licensing agreement or a license.

Copyright holders may enforce their rights in court and criminal sanctions may apply for violations.

A patent is obtained from the Patent Office. Under Latvia's patent law, the creator's rights are protected if an application has been submitted to the Patent Office. These rights are also retained by a person who has filed the first application in a state that is party to the Paris Convention for the Protection of Industrial Property, and who has, in accordance with the provisions of the Paris Convention, filed an application for the same invention with the Patent Office within 12 months. A registered European patent has the same legal effect as a Latvian patent.

Trademarks are registered and protected under the Law on Trademarks and Geographic Indications by registering the mark. Trademarks that are well known in Latvia are protected without registration. The registration is valid for 10 years from the application date and the registration may be extended. The law does not set a limit on the number of extensions but re-registration must be carried out in the year preceding the expiration of the patent.

1.2 Currency

Latvia's currency is the Lat (LVL).

The Bank of Latvia (central bank) implements a policy of a fixed national currency exchange rate (EUR 1 = LVL 0.702804), with the monetary base fully backed by the central bank's foreign exchange reserves. The bank is preparing the country for full-fledged participation in the Economic and Monetary Union (EMU).

1.3 Banking and financing

Both domestic and foreign banks offer banking services in Latvia. A single authority, the Financial and Capital Market Commission (FCMC), supervises the financial sector, in order to ensure the overall stability of the financial and capital markets. The FCMC issues guidance on the activities of market participants, licenses participants and products in the financial and capital markets, and monitors compliance.

The legislative framework for banking in Latvia meets EU requirements, and in some areas is even stricter. International Financial Reporting Standards (IFRS) have been fully recognized; the annual reports of the banks are prepared in accordance with IFRS and audited by internationally recognized auditing firms. The practical supervision of banking in Latvia is highly supervised and bank inspections are conducted more frequently than in other EU member states.

A bank licensed in another EU member state may establish a branch and provide financial services as set forth in the license issued by the foreign supervisory authority if the FCMC has

received notification from the foreign supervisory authority about the branch's activities. A bank licensed in an EU member state may provide financial services in Latvia without establishing a branch after the foreign supervisory authority has transferred to the Latvian supervisor the business plan of the bank indicating the financial services it intends to provide.

Latvia has rules for measuring the performance of credit institutions and reporting requirements that conform to EU standards. It has also implemented the relevant EU directives on the prevention of money laundering, which requires customer identification and record-keeping on all transactions, identification of suspicious and unusual transactions, and reporting to the Board of Prevention of Legalization of Proceeds from Criminal Activities.

The financial center of Latvia is the capital, Riga.

1.4 Foreign investment

Reforms in Latvia have strengthened the private sector, created macroeconomic conditions favorable for growth and helped to improve the business environment, thus attracting the attention of international investors worldwide.

The Investment and Development Agency promotes business development by facilitating foreign investment and working to increase the competitiveness of Latvian entrepreneurs in both domestic and foreign markets.

Latvia has signed bilateral agreements on the mutual promotion and protection of investments with a number of countries, including: Armenia, Austria, Azerbaijan, Belgium, Belarus, Bulgaria, Canada, China, Croatia, the Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Georgia, Hungary, Iceland, Israel, Italy, Kazakhstan, Korea, Kuwait, Lithuania, Luxembourg, Moldova, the Netherlands, Norway, Poland, Portugal, Romania, Singapore, Slovakia, Spain, Sweden, Switzerland, Taiwan, Turkey, U.K, Ukraine, U.S. and Vietnam. These agreements prescribe a standard treatment for investments and profits related to foreign persons, together with protection from potentially harmful consequences caused by state institutions interfering with foreign investments and profits.

1.5 Tax incentives

As from 1 January 2011, a "substantial investment" tax incentive regime provides corporate income tax relief. The regime, which is designed to attract new investment, applies to long-term investments in manufacturing, telecommunications, computer programming facilities, storage and transport auxiliary works. The relief amounts to 25% of the amount of the investment up to LVL 35 million (approximately EUR 50 million), and 15% of investments exceeding this amount. The following requirements must be met to qualify for the relief:

- The minimum amount of the investment is LVL 5 million (about EUR 7 million);
- The investment is made within three years from the date the Latvian government agrees to support the project;
- The investment is made in the specified industry;
- The investment results in a new business line or the modernization/expansion of an existing business line, such as the manufacturing of a new product, changing a process, etc.;
- The investment is made in unused manufacturing technological equipment, telecommunications and computer programming equipment, or buildings and construction; and
- The investment is in the course of the investor's business and related to the investor's business activity.

Further, there are four free zones in Latvia: the Riga and Ventspils Free Ports and the Liepaja and Rezekne Special Economic Zones (SEZ). The free zones, approved as compatible with the EU state aid rules, were established in 1997 for a 20-year period to encourage Latvia's participation in foreign trade, attract investment, develop production and services, and create new jobs.

Licensed companies operating in these areas are entitled to reductions in direct and indirect tax rates. Incentives include:

- An 80% rebate of corporate income tax on income derived by licensed companies from business activities within the zone (the tax relief may not, however, exceed 25%-70% (depending on the criteria in the law) of the investment value;
- An 80% rebate of withholding tax on dividends, royalties and management fees; and
- The carryforward of losses, rebate of real estate tax, etc.

A company must sign an agreement with the free zone to qualify for the incentives and obtain a license to carry out business activities in the zone.

The Liepaja SEZ is located in the port city of Liepaja on the south-west coast, and covers nearly two-thirds of the city territory, including the port, industrial areas, the airport and the former navy base, Karaosta.

The Rezekne SEZ is situated in the city of Rezekne in the south-east of Latvia, near the Russian border. This SEZ is designed to help diversify investment away from Riga to a relatively undeveloped area, but has only limited impact, although wood processing enterprises, one of the priority sectors, are developing successfully. The output of Rezekne enterprises is mainly targeted to eastern markets.

The Riga Free Port is located near the capital and is open for navigation year round. The Free Port is expanding with the goal of becoming one of the leading ports in the Baltic region and providing effective distribution, warehousing and acquisition services.

The Ventspils Free Port, an ice-free port, is the leading port on the Baltic Sea and among the top 15 European ports in terms of cargo turnover. The Ventspils Free Port has the largest crude oil and oil product trans-shipment terminal and the largest liquid chemicals trans-shipment terminal in the Baltic Sea Region, and the second largest potash trans-shipment terminal in the world. The port has a highly developed infrastructure linked to the crude oil and oil product pipeline system and railway network of Russia and other members of the Commonwealth of Independent States.

1.6 Exchange controls

The Latvian government does not have any controls over the import, export, use or exchange of foreign currency in Latvia. Lats may be exchanged for any convertible currency in banks and exchange bureaus. The Bank of Latvia grants cash exchange licenses to Latvian companies, provided the founders and owners of the enterprise have a good reputation.

The Bank of Latvia has adopted the Regulation for Buying and Selling Cash Foreign Currency, and Recommendations to Currency Exchange Bureaus for Developing Procedures for Identification of Suspicious and Unusual Transactions. The Recommendations also require that such enterprises identify customers in cases established by the Law on the Prevention of Laundering of Proceeds Derived from Criminal Activity.

2.0 Setting up a business

2.1 Principal forms of business entity

The following forms of business entities are available in Latvia: individual merchant, general partnership, limited partnership, limited liability company and joint stock company. European Companies (*Societas Europaea*, or SE) and the European Economic Interest Grouping also are available, the latter providing an opportunity for Latvian individuals and legal persons to join international partnerships with members from other EU member states.

An individual merchant is an individual who is registered as a merchant with the Commercial Register. An individual merchant is fully liable for his debts.

A general partnership is a partnership with the purpose of carrying out commercial activities, and in which two or more persons are united under a common business name, on the basis of a partnership agreement. The partners in a general partnership are jointly liable for the obligations of the partnership with all their assets.

In a limited partnership, at least one of the partners is a limited partner, who is liable for the obligations of the limited partnership to the extent of his contribution; the general partners are liable for the partnership debts with all their assets.

The share capital of limited liability and joint stock companies is divided into shares or stock. These are the most popular forms of investment vehicle. Both entities have all the rights of a juridical person. In practice, the most common business form is the limited liability company, because it requires fewer organizational formalities and less statutory capital.

An SE is a stock company with that advantage that it can move its legal address from one EU member state to another without liquidating the company.

Formalities for setting up a company

To set up a company in Latvia, the founder(s) must prepare and sign the company's articles of association, form the company's governing bodies, subscribe for the share capital, pay the relevant fees and register the company with the Registry of Enterprises. The registration application must be signed by all founders and be notarized.

Entries made in the Commercial Register are promulgated by publishing an announcement in the official newspaper, *Latvijas Vēstnesis*, and simultaneously in electronic form in the official database, *Lursoft*.

Forms of entity

Requirements of an LLC and a JSC

Capital. *LLC:* An LLC can be established with a minimum statutory capital of LVL 2,000, while a micro LLC can be founded with a minimum statutory capital of LVL 1. The shares of an LLC may not be publicly traded. *JSC:* The minimum statutory capital of a JSC is LVL 25,000; higher amounts are required to establish banks, insurance companies and currency exchanges. The establishment of a branch of a foreign bank is subject to the approval of the Bank of Latvia. Only JSCs are allowed to make public share offerings.

Founders and shareholders. *Both:* An LLC and a JSC can be formed by one or more individuals or legal persons. A nonresident may be the sole owner.

Board of directors. *Both:* A board of directors, which is appointed by the supervisory council, may consist of a single individual or of two or more individuals, unless the company's shares are publicly traded, in which case there must be at least three board members. All board members

must be individuals and a member of the supervisory board may not also be part of the board of directors. The supervisory council is responsible for supervising the board of directors. The council, elected for a five-year term, must have at least three, but no more than 20, members. There are no restrictions on a foreigner accepting the position of director or member of the council.

Management. *Both:* The administrative bodies of a company are the meeting of shareholders and the board of directors, as well as the supervisory council (the latter is mandatory for JSCs). The supervisory council represents the interests of shareholders and supervises the activities of the board of directors.

Taxes and fees. *Both:* The standard state fee for registering an LLC is LVL 100 and LVL 250 for a JSC. The fee should be paid before the application is submitted, and this can be done in any banking institution.

Type of shares. *LLC:* The capital of an LLC is divided into shares, which must have a par value of a whole number of LVL. All shares must confer the same rights; preference shares or different classes of shares are not permitted. *JSC:* The shares of a JSC may be registered or bearer, and may be ordinary, preference or employee shares.

Branch of a foreign corporation

Branch offices are regulated by the Commercial Law and may be established by foreign or local companies. Branch offices must be registered with the Commercial Register.

A branch of a non-resident company is treated as a separate Latvian taxpayer and is subject to the same reporting and audit requirements that apply to domestic companies. A branch for tax purposes is treated as an independently operating entity subject to certain adjustment for transactions carried out with the head office. The head office is fully liable for the activities of its branch. As a general rule, a branch of a nonresident company is taxed the same as a subsidiary. There is no separate branch profits tax.

Representative office

A representative office also may be established by a foreign company, but a representative office may not engage in commercial activities and it does not have the status of a separate legal entity, although it can be active in advertising and promoting the business of the head office.

2.2 Regulation of business

Mergers and acquisitions

Mergers and acquisitions in Latvia are generally governed by the Commercial, Civil and Competition Laws. The Commercial Law regulates the reorganization of companies, such as mergers, divisions or restructurings, and sets forth general rules for the transfer of shares and assets. The main principles regarding transactions, contracts, and the rights and obligations of the parties are governed by the Civil Law. Mergers are subject to the Competition Law if the combined turnover of the participants during the previous financial year exceeded LVL 25 million and the combined market share of the market participants involved in the merger exceeds 40%. These rules apply in the following cases:

- The merger of two or more independent market participants;
- The amalgamation of one market participant to another market participant (acquisition); or
- Where one or more individual(s) already exercising decisive influence over a market participant acquires all or part of the fixed assets of another market participant or the right to utilize a decisive influence over another market participant.

The Competition Council monitors and ensures compliance with the Competition Law. Market participants covered by the law that wish to merge must submit advance notification to the Council to obtain permission.

Other laws may also affect mergers and acquisitions, including the Financial Instruments Market Law, which imposes additional requirements on companies listed on stock exchanges.

Merger and division transactions are described in detail in the Commercial Law. An acquisition is a process in which a company transfers all of its assets to another company. In a consolidation, two or more companies transfer all of their assets to a newly founded company. Consequently, all rights and obligations of the acquired company (or companies) are transferred to the acquiring company, the acquired company (or companies) cease(s) to exist without liquidation and the shareholders of the acquired company (or companies) become shareholders of the acquiring company.

If an undertaking or an independent part of it is transferred, the buyer usually acquires a part of a company's assets. All claims and other rights included in the undertaking or its part are transferred to the purchaser. The buyer and seller are jointly liable for all obligations that become due within five years after the transfer.

The Commercial Law does not impose any restrictions on the alienation of the assets of a company, but the company's articles of association may contain additional rules, such as prior consent of the shareholders' meeting or the council of the company.

Monopolies and restraint of trade

Historically formed monopolies dominate the state-regulated sectors in Latvia and some services are provided under conditions of a natural monopoly. Although the electric, gas and rail markets are gradually being opened up to competition, these markets are currently dominated by large companies.

The Competition Law includes EU standards, whereby a market participant who has a dominant position is prohibited from abusing this position in Latvia. The Competition Council is responsible for ensuring compliance with the law.

2.3 Accounting, filing and auditing requirements

Financial statements must be submitted annually. The annual report must be audited by a sworn auditor if two of the following criteria are exceeded: (1) total assets of at least LVL 250,000; (2) net sales of at least LVL 500,000; and (3) the average number of employees is at least 25.

Accounting must be done in Latvian Lats and the exchange rates of the Latvian Central Bank should be applied to transactions in other currencies. Bookkeeping is based on requirements in the Law on Accounting, but it contains only general regulations. Records should be kept in Latvian or be readily translated in the event of an audit by the tax authorities.

Local GAAP has been developed, but application is not mandatory. Local GAAP is to a large extent similar to IFRS and IAS, which are used mainly as guidance and mandatory only for banks and insurance companies.

3.0 Business taxation

3.1 Overview

In addition to corporate income tax, companies doing business in Latvia are subject to value added tax (VAT), real estate tax, customs and excise duties, social security contributions and a natural resources tax.

Latvia has implemented most of the EU directives, including the parent-subsidiary and merger directive, and currently applies an eight-year transition period (until 1 July 2013) to implement the interest and royalties directive. Latvia also has implemented the EU savings directive, which requires the exchange of information between tax administrations when interest payments are made in one EU member state to an individual resident in another member state.

3.2 Residence

A corporation is resident if it is established and registered – or required to be established and registered – in Latvia.

3.3 Taxable income and rates

Resident companies are taxed on their worldwide income, and nonresidents are subject to tax on income earned or sourced in Latvia.

The corporate income tax rate on resident companies, permanent establishments (PE) of nonresidents and any other entities deriving business income in Latvia is 15%.

Taxable income defined

Taxable income is calculated based on the profit or loss as calculated in the annual income statement adjusted for nontaxable and nondeductible items as provided by the tax law. Corporate income tax is levied on all types of business income, including business profits, dividends, interest income, royalties and rental income.

Dividends from domestic subsidiaries and qualifying EU/EEA companies are exempt from tax. Dividends received from entities in non-EU/EEA countries are exempt if the Latvian recipient holds more than 25% of the capital and voting rights of the payer and the payer is not located in a “black list” country. If a partnership distributes business income to a foreign partner, it must withhold tax at 15%.

Business income derived by investment funds, general and limited partnerships, as well as co-operative societies, is taxed only in the hands of the investors and partners.

Deductions

Expenses directly related to the business of a company and, thus attributable to the generation of taxable income, are deductible for tax purposes. Deductible expenses include interest (subject to the thin capitalization rules), royalties, employees’ remuneration, directors’ fees, service and management fees and R&D costs. Certain expenses that are not directly concerned with the business of the company may be deducted (e.g. representation expenses), but the deduction is limited to 40% of the expense. Some expenses are specifically nondeductible, generally because they are not “directly” related to the business of a company, e.g. expenses for recreational activities of owners and employees, expenses for private travel, gifts, credits and loans turned into gifts for employees, as well as penalties, fines and interest for late payments.

As from 1 January 2011, a tax relief is granted for “substantial investments” (see above under “Tax incentives”).

Limits are imposed on the deductibility of expenses incurred by a PE, such as rent, interest or for services, including management and consulting services and technical assistance, paid to the head office.

Depreciation

Fixed assets used for business purposes generally may be depreciated using the declining balance or the straight-line method.

Under a special tax depreciation regime for new manufacturing equipment, which applies until 2013, the acquisition value of new manufacturing equipment for tax depreciation purposes is multiplied by 1.5. The increased rate also applies to patent and trademark development costs if a new patent and/or trademark is registered.

Intangible assets, such as concessions, patents, licenses and trademarks may be amortized using the straight-line method. Concessions are amortized over 10 years, and patents, licenses and trademarks over five years provided that they do not expire earlier. Copyrights, goodwill and other intangible assets may not be amortized for tax purposes.

R&D expenses may be written off in the year the costs are incurred.

If fixed assets are leased without an option to purchase (e.g. an operating lease) and are to be returned to the owner at the end of the lease, or if a lease agreement provides for the reconstruction, improvement or renovation of fixed assets, the lessee may write off the amount of such costs in equal parts over the remaining period of the lease. If the lessor compensates the lessee for such expenses, the amount of the reimbursement must be included in the lessee's taxable income.

Reserves/provisions

Although there are no rules permitting tax-free reserves, certain types of companies are permitted to deduct contributions allocated to specific provisions and reserves (e.g. credit institutions can deduct contributions to their statutory deposit insurance funds and provisions made for doubtful debts, insurance companies can deduct allocations to special technical reserves).

Losses

Tax losses may be carried forward for eight years, but the carry back of losses is not permitted. However, where there is a change in the control of a company, the carryforward of existing losses will be forfeited unless the company continues the same business activities for the subsequent five years. If a company merges, the absorbing company (under certain conditions) may utilize the losses of the absorbed company.

Latvia permits a group of companies to surrender losses to other companies in the group. A parent company, for purposes of the group relief rules, is a Latvian or another EU/EEA legal entity owning at least 90% of the capital of a subsidiary or subsidiaries, the parent company and one of its subsidiaries, or any combination thereof. If a group company incurs losses, the taxable income of another group member or several members may be reduced by the amount of that loss. Losses may be transferred to another group company only if both companies have been a member of the same group for the whole tax period and are not exempt from tax. In addition, the annual accounts of both companies must be audited and neither company can have any outstanding tax debts.

3.4 Capital gains taxation

Latvia does not levy a separate capital gains tax -- gains are taxed as general business income at the normal corporate rate of 15%. Gains derived from the sale of publicly listed shares traded on the regulated securities markets of the other EU/EEA Member States, however, are tax-exempt (and expenses directly related to the sale of shares of publicly listed companies are non-

deductible). Losses incurred on the sale of unlisted securities are not deductible unless the shares were held by the taxpayer for more than 12 months and the company sells the shares only once per year.

Capital gains derived from the sale of shares are normally calculated as the difference between the acquisition price and the sales price. The revaluation of shares does not give rise to taxable income until the profits crystallize.

Capital gains on the sale of property are calculated as the difference between the net tax value of property and the sales price.

3.5 Double taxation relief

Unilateral relief

Latvia generally applies the credit method to avoid double taxation, both unilaterally and in its tax treaties. To apply the unilateral method, sufficient supporting documentation of the tax suffered abroad must be available.

Tax treaties

Latvia has a solid tax treaty network, the aim of which is to eliminate double taxation and provide for reduced rates of withholding tax on dividends, interest and royalties. The treaties generally follow the OECD model treaty, providing for relief from double taxation on all types of income, limiting the taxation by one country of companies resident in the other and protecting companies resident in one country from discriminatory taxation in the other. The treaties also adhere to the internationally agreed exchange of information requirements.

The treaty can be applied through obtaining a resident certificate, which is a separate procedure. Both the tax payer and the receiver have to work together to obtain the certificate, the signatures of both tax authorities are required.

Latvia Tax Treaty Network			
Albania	Finland	Lithuania	Singapore
Armenia	France	Luxembourg	Slovakia
Austria	Georgia	Macedonia	Slovenia
Azerbaijan	Germany	Malta	Spain
Belarus	Greece	Moldova	Sweden
Belgium	Hungary	Montenegro	Switzerland
Bulgaria	Iceland	Morocco	Tajikistan
Canada	Ireland	Netherlands	Turkey
China	Israel	Norway	Ukraine
Croatia	Italy	Poland	United Kingdom
Czech Republic	Kazakhstan	Portugal	United States
Denmark	Korea (R.O.K.)	Romania	Uzbekistan
Estonia	Kyrgyzstan	Serbia	

3.6 Anti-avoidance rules

Transfer pricing

Transfer pricing rules apply to transactions between related parties, whether resident or nonresident. Thus, if goods or services are sold to a related company below market price, or

purchased from a related company or a related person above market price, the taxable income of the Latvian taxpayer may be adjusted by the tax authorities based on the effective market price. There are no special documentation requirements, but the OECD guidelines may be applied to substantiate a transaction price.

Under Latvian law, three transactional transfer pricing methods prevail: comparable uncontrolled price, cost plus and resale method. Two profit-based methods (i.e. the transactional net margin method and the profit split method) may be used if the first three methods are not sufficient for determining the arm's length price.

Pending changes to Latvia's transfer pricing rules are expected to become effective in 2012. The amendments include a requirement for residents and PEs of foreign companies to maintain documentation if the company's annual turnover exceeds LVL 1 million and transactions are carried out with:

- Related persons (companies) that are foreign enterprises;
- Related persons (companies) that are part of the same tax group;
- A company or co-op that is exempt from corporate income tax or that benefits from corporate income tax reliefs;
- Related individuals; and
- Other companies or individuals that are located or established in tax havens.

The documentation will have to contain the following:

- General overview of the industry;
- Organizational and legal structure of the related parties;
- The taxpayer's tax strategy;
- Information on the business process;
- Description of the services or products and transactions;
- Description of the transfer pricing methodology; and
- Financial analysis of comparable transactions between unrelated companies or an analysis of comparable prices in unrelated party transactions.

Thin capitalization

Latvia's thin capitalization rules restrict the deduction of interest payments. Two methods apply to determine whether interest is deductible: (1) interest exceeding 1.2 times the average annual short-term credit rate; and (2) a 4:1 debt-to-equity ratio. Thus even if the interest is at a "market" rate, the deduction will be limited if the debt-to-equity ratio exceeds 4:1. If both restrictions apply, the taxable amount must be increased by the greater amount.

The restriction does not apply to interest payments made to credit institutions established in Latvia or another EU member state, nor does it apply to interest payments to the state treasury, a member of the group of the Nordic Investment Bank or the World Bank.

Controlled foreign companies

Although Latvia does not have CFC legislation, payments made by residents of Latvia to entities or individuals registered or domiciled in low- or zero-tax countries and territories included on the government's black list are subject to a special withholding tax of 15%. The tax authorities may exempt payments from this requirement if certain conditions are satisfied.

General anti-avoidance rule

There are no general anti-avoidance rules in Latvia, with the exception of transactions made with entities located in jurisdictions on the black list. Such transactions are considered to be transactions with related parties and, therefore, the transfer pricing rules apply. A 15% withholding tax is levied on payments to these jurisdictions.

3.7 Administration

Tax year

The taxable period for corporate income tax corresponds with the annual accounting period, and it normally coincides with the calendar year.

Filing and payment

Small and medium-sized companies must file a tax return within four months after the end of the financial year and large companies must file within seven months. All companies must make monthly advance payments based on the previous year's profits.

Interest and penalties apply for the failure to file a timely or an incorrect return. A company may file an amended return or an adjustment to a tax assessment within three years after the required payment date.

Consolidated returns

Latvia does not allow group consolidation for tax purposes, but does permit a group of companies to surrender losses to other companies in the group (see above under "Losses").

Statute of limitations

The statute of limitations is three years from the end of the tax period in which the tax return was due, unless the tax authorities are conducting an audit or criminal activities are suspected.

Tax authorities

The State Revenue Service (SRS) is the institution responsible for the administration of tax in Latvia. The responsibilities of the SRS include:

- Recording and registering taxpayers and taxable objects;
- Collecting tax and duties and other payments;
- Conducting audits; and
- Carrying out information exchanges as the competent authority for Latvia.

Rulings

The Latvian tax authorities may provide a binding advance ruling on the tax consequences of a proposed transaction, but it is a difficult and seldom used procedure.

3.8 Other taxes on business

Natural resources tax

Natural resources tax is levied on taxpayers engaged in extractive activities or first selling packaged goods. Certain exemptions are available.

4.0 Withholding taxes

4.1 Dividends

There is no withholding tax on dividends if the recipient is an EU/EEA resident company. In other cases, dividends paid by a Latvian resident company to a nonresident legal entity are subject to a 10% withholding tax unless the rate is reduced under a tax treaty.

4.2 Interest

A withholding tax of 10% applies to interest paid by Latvian resident companies to associated nonresident companies; the rate is 5% if paid by a commercial bank to an associated nonresident company.

Under the transitional rules for implementation of the EU interest and royalties directive, a 5% tax will be withheld from interest paid by Latvian resident companies to associated EU companies. That rate will be reduced to 0% as from 1 July 2013.

4.3 Royalties

Royalties paid to a nonresident are subject to a 5% or 15% withholding tax (depending on the type of royalty) unless the rate is reduced under a tax treaty.

Under the transition rules in the EU interest and royalties directive, Latvia is permitted to apply a 5% withholding tax regarding associated EU companies; the full exemption does not apply until 1 July 2013.

4.4 Branch remittance tax

Latvia does not impose a branch remittance tax.

4.5 Wage tax/social security contributions

An employer in Latvia is required to pay social security on behalf of its employees. The combined social security rate is 35.09% of the employee's gross income (11% paid by the employee and 24.09% by the employer). Reduced rates apply for special categories of employees. Social security contributions cover old age pensions, unemployment, work accidents, disability, maternity and illness.

4.6 Other withholding taxes

Rental payments made to a non-resident for the use of property in Latvia are subject to a 5% withholding tax. Management fees are subject to a 10% withholding tax unless the nonresident is entitled to an exemption under a tax treaty and the nonresident does not have a PE in Latvia.

5.0 Indirect taxes

5.1 Value added tax

Value added tax (VAT), which is levied on the sale of goods, the supply of services and imports, is based on the EU directives. The standard rate is 22%, with a reduced rate of 12% applicable to certain goods and services. Certain exports and related supplies are zero-rated and some supplies (e.g. medical services, rentals of apartments, and banking and insurance services) are exempt.

A Latvian company may register for VAT immediately after it is registered with the Commercial Register. A company is obliged to register if the total value of its VAT taxable transactions reaches or exceeds LVL 35,000 during the preceding 12 months. Foreign entities (from the EU or elsewhere) that carry out VAT-taxable transactions in Latvia must register for VAT purposes before commencing transactions, irrespective of the amount of the transactions, unless the reverse-charge method applies.

If input VAT exceeds output VAT, the VAT payer may request a refund. Subject to certain conditions, a refund may also be granted to a foreign entity that has paid Latvian VAT on goods or services purchased in Latvia.

The tax period is the calendar month, with some exceptions. VAT payers must submit the VAT return within 15 days after the end of the tax period.

Latvia allows for the establishment of a VAT group, which may consist of companies that are members of the same concern and Latvian branches of foreign companies, provided the company in question is also a member of the same concern as the other members of the VAT group. Once an election is made to set up a VAT group, the group must be maintained for at least 12 months. A VAT group is considered a single taxable person with its own VAT registration, with one member of the group filing the group's VAT returns. Transactions between members of a VAT group are outside the scope of VAT.

5.2 Capital tax

No capital tax is levied in Latvia.

5.3 Real estate tax

Real estate tax is paid by domestic and foreign companies that have a title (registered with the Land Registry) or legal possession of real estate in Latvia. The local authorities levy a real property tax equal to 1.5% of the cadastral value of land and buildings. A 3% tax is levied on agricultural land not in use.

5.4 Transfer tax

The sale of property or a real estate company by a nonresident to a Latvian resident is subject to a 2% withholding tax.

5.5 Stamp duty

Stamp duty is levied on the registration of property by a legal entity. The rate is 2% of the higher of the sales price or cadastral value, capped at LVL 30,000. Different rules apply to reorganizations and contributions in kind.

5.6 Customs and excise duties

Customs duty is imposed on goods imported in Latvia from countries outside the EU upon their release for free circulation. The duty is based on the common customs tariff applicable in all EU member states. In general, the rates are calculated as a percentage of the customs value of the goods (e.g. 0%, 12%) or on a volume basis (fixed rate per unit). The tariff may differ depending on the country of origin of the product.

Excise duty is imposed on oil products, alcoholic and non-alcoholic beverages and tobacco products. The duty is calculated either as a percentage of the value of the goods or on a volume basis (fixed rate per unit). Latvian excise duty legislation is in accordance with EU rules. Duty payments may be suspended if goods are moved between excise warehouses of EU member states. The duty becomes due when the goods are released for free circulation.

5.7 Environmental taxes

Natural resources tax is levied on taxpayers engaged in extractive activities or first selling packaged goods. Certain exemptions are available.

5.8 Other taxes

Tax on lotteries and gambling

The tax on lotteries and gambling is levied on businesses that have a license to organize and run lotteries and gambling games. In addition to the tax, a duty or license fee must also be paid.

6.0 Taxes on individuals

Individuals in Latvia are subject to a number of taxes, including income tax, real estate tax and social security contributions.

6.1 Residence

Individuals who are permanent residents of Latvia or who are present in Latvia for more than 183 days in a 12-month period are considered tax residents of Latvia.

6.2 Taxable income and rates

Resident individuals are subject to tax on their worldwide income. Individuals who are not residents of Latvia are only liable to tax on their Latvian-source income.

Income is taxable in the year in which it is paid to the individual's account or the individual otherwise has received control over the income.

Taxable income

Individuals are taxed on employment income and benefits, business income, pension income, investment income and all other income. Exempt income includes the following:

- Insurance indemnities, except for indemnities paid on life insurance, medical expenses and personal accident insurance arranged by the employer for the benefit of the employee
- Income from government bonds of Latvia or another EU member state; and
- Inheritance income, excluding copyright royalties paid to heirs.

Salaries, various kinds of bonuses and benefits received on the basis of employment (company-provided housing, company car, lunch vouchers, etc.) are considered taxable employment income.

Employee pension insurance and endowment premiums paid by the employer to funds and insurance companies registered in EU/EEA member states can be tax-exempt for the employee up to 10% of the employee's gross annual salary. Non-savings life, health and accident insurance premiums paid by the employer for an employee can be tax exempt up to LVL 300 (about EUR 427). These exemptions are applicable if a savings-based agreement is concluded for at least five years and a non-savings agreement for at least a year.

Daily allowances, mileage allowances and other reimbursements related to business trips and paid within the limits set by the Cabinet of Ministers are not taxable.

Benefits received on stock options, share purchase plans and other equity-based plans are taxable income. The benefit is considered to be received when the option is exercised. If exercised by subscribing to the shares, the taxable income is the difference between the fair market value of the shares and the exercise price increased by the amount (if any) the employee paid for the option. If the option is sold, the taxable income is the sales price less the amount (if any) the employee paid for the option.

Deductions and reliefs

In 2011, resident individuals are entitled to a monthly nontaxable personal allowance of LVL 45 and an allowance of LVL 70 for each dependent.

Rates

The tax rate on all income of a resident individual is 25% (the 15% rate that previously applied to business income is also subject to the 25% rate). Income from capital and dividends received from EU/EEA resident companies, previously classified as tax exempt, is subject to tax: a 15% rate applies to capital gains (e.g. sale of shares) and a 10% rate to other types of income from capital (dividends, securities and interest income).

The withholding tax rates applicable to nonresidents are as follows:

- Dividends: 10%;
- Income from participation in a partnership: 25%;
- Interest: 25%, except for interest from investments and deposits in credit institutions and savings companies registered in Latvia and other EU member states, and income from mortgage bonds;
- Royalties: 15% (for the use of a patent); and
- Income from rent and the sale of real estate: 25%.

Nonresident individuals owning real estate in Latvia must include gains derived from the sale of property in their annual taxable income and pay income tax of 25%. The sale of real property by a nonresident to a Latvian resident is subject to a 2% withholding tax.

6.3 Inheritance and gift tax

Gifts from relatives are tax-exempt, but gifts in excess of LVL 1000 annually received from nonrelatives are subject to a 25% tax. There is no inheritance tax.

6.4 Net wealth tax

Latvia does not levy a net wealth tax.

6.5 Real estate tax

Real estate tax is paid by individuals that have a title (registered with the Land Registry) or legal possession of real estate in Latvia. The local authorities levy a real property tax equal to 1.5% of the cadastral value of land and buildings. The tax rate for residential property, which is not used for commercial purposes ranges from 0.2% to 0.6%. A 3% tax is levied on agricultural land not in use.

The sale of property or a real estate company by a nonresident to a Latvian resident is subject to a 2% withholding tax.

6.6 Social security contributions

Social security contributions are levied on both the employee and the employer. The general contribution is 35.09%, which consists of an employer part of 24.09% and an employee part of 11%.

6.7 Compliance

The tax year for individuals is the calendar year.

Individuals are generally required to file an annual tax return by 1 April of the year following the tax year.

7.0 Labor environment

7.1 Employee rights and remuneration

The main act governing employment relations in Latvia is the Labor Law, which generally corresponds to EU requirements. All individuals are granted equal rights in employment relationships regardless race, color, gender, age, disability, etc.

Employment contracts must be in writing and set out items such as the term of the contract (if the contract is for a specific period), a description of the work, the employee's position, remuneration and time of payment, working hours, etc.

Working hours

Normal work hours may not exceed eight hours per day and 40 hours per week. In general, an employee must consent in writing for overtime work. Special requirements apply to night shifts or jobs involving irregular hours. A five-day work week is specified for employees, although where the nature of the work makes it impossible to comply with the regular daily or weekly work times for the relevant category of employees, the employer, after consultation with the employee, may prescribe an aggregated working time, which may not exceed 56 hours per week and 160 hours within a four-week period, unless otherwise provided by a collective agreement or an employment contract.

Employees are not required to work on public holidays. If it is necessary to ensure the continuity of the work, an employee may work on a holiday and have another day off or be paid appropriate compensation.

7.2 Wages and benefits

The official minimum wage in 2011 is LVL 200 per month and LVL 1.189 hourly. Employers are not required to provide fringe benefits to their employees.

Pensions

Latvia has a three-tier pension system: the first tier (state compulsory unfunded pensions), the second tier (state-funded pension) and the third tier (private voluntary pension). The three pension tiers ensure the financial stability of the system:

- All persons making social insurance contributions fall within the first tier. Current contributions are used for payment of old-age pensions to existing pensioners.
- The social insurance contributions of those who participate in the second tier are invested in the financial market through chosen fund managers and saved for the pension of the specific contributor.
- The third tier ensures the possibility for all individuals to create additional savings for their pension.

The old-age pension is calculated and granted in accordance with the Law on State Pensions. The "premature" old-age pension, taken before an individual reaches the statutory retirement age, is 80% of the full pension entitlement, but it may not be lower than 110% of the state social insurance benefit.

Social insurance

Social insurance covers the risk of lost employment as a result of age, unemployment, workplace accident or occupational disease, disability, illness, maternity and additional costs in

the event of death of the insured or the person supported by him or her. Social insurance benefits include state pension, unemployment, work accidents and occupational diseases, disability, maternity and sickness.

Compulsory social insurance contributions are determined by law and paid into a special fund that gives an insured person the right to receive social insurance services.

Resident employers must pay national social insurance on a monthly basis; contributions from employees of foreign companies must be made and reported quarterly.

7.3 Termination of employment

An employee may be dismissed for cause, if the contract has a specified date for termination or if the business of the employer is to be liquidated. The amount of severance pay, if any, depends on the length of time the individual worked for the employer.

If the employer engages in a collective dismissal, it must first consult with the employee representatives.

7.4 Labor-management relations

Although collective agreements are not used frequently, and are largely confined to enterprise level, trade unions have the right to insist on negotiating such agreements. Collective agreements can contain provisions regarding wage rates, working hours, holidays, benefits, workplace safety and other working conditions. Conflicts may be resolved either by special dispute commissions or in court.

7.5 Employment of foreigners

No work permit is required for EU/EEA citizens or any member of their family. Unless an exception applies, third-country nationals should obtain a work permit. Latvian legislation does not restrict the number of foreigners employed by Latvian companies.

According to government regulations, an offer by an employer for a foreign citizen (except for EU citizens) to work in Latvia must first be approved by the State Employment Service. The Office of Citizenship and Migration Affairs issues the work permit on the basis of an affirmative decision, in addition to visa or residence permits.

8.0 Deloitte International Tax Source

Professionals of the member firms of Deloitte Touche Tohmatsu Limited have created the Deloitte International Tax Source (DITS), an online resource that assists multinational companies in operating globally, placing up-to-date worldwide tax rates and other crucial tax material within easy reach 24/7.

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