Study on fair international taxation policy

Reference material for protection of interests
In Latvia we sometimes speak about the personal and corporate social responsibility, however, we have focused less on the paradigm of a socially responsible country vs other global countries. The authors refer to the state social responsibility as dual processes: implementation of the policy which does not cause unfavourable consequences for the residents of this country and for other countries; assistance in elimination of current social problems both in its own country and in other countries, in particular, in developing countries.

Within the context of the state social responsibility it is possible to speak, for example, about its responsibility regarding the greenhouse effect, use of children labour, inconsiderate use of natural resources, contribution to the growth of poverty of developing countries and other aspects. Socially responsible policy also means that a country does not only implement development projects in the poorest countries, but also prevents the possibilities of utilizing its jurisdiction for maintaining or increasing poverty both internally and in other countries.

In the present study the authors will analyse how the policy of forming and collecting the Enterprise Income Tax in developed countries can increase poverty both in one’s own country and increase the gap between developed and developing countries, as well as, by performing deeper analyses, will assess the place and the role of Latvia in these processes.

The study is performed within the project „Fair taxes for everyone”, financed by the European Union and implemented by the international cooperation network of non-governmental organisations Tax Justice Network. The project partner and implementer in Latvia is the Association „Latvijas Platforma attīstības sadarbībai” /the Latvian Platform for Development Cooperation/ (LAPAS), and its goal is to collect and analyse the information that can be practically used for protection of interests.
Study on fair international taxation policy
Reference material for protection of interests

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Summary

The review of a number of studies, policy documents and other publications has led the authors to conclude that the currently existing national tax policy in a number of countries, and international agreements fail to prevent international tax avoidance. On the contrary, in many cases, they contribute to tax dodging. If the companies evade taxes on the international scale, the losers mostly are the poor and developing countries, as well the poorest people in the wealthier countries.

Interrelated factors that contribute to the tax evasion on the international scale:
- national competition for investment resulting in low taxes for certain types of income;
- unfair tax agreements between countries;
- secrecy in the financial and banking sector;
- insufficient control over the internationally structured businesses.

Some of the conditions can be prevented within countries, while others can be eliminated only at the international level, when countries agree on common policies and actions. Internationally, combating tax evasion is advocated by intergovernmental organizations: Organisation for Economic Co-operation and Development, the European Union, international non-governmental organizations (such as the Tax Justice Network), as well as the United Nations’ multilateral initiative Open Government Partnership.

Latvia does not have an extensive economic cooperation with poorest countries, and no bilateral tax treaties so far have been concluded with these countries. It suggests that Latvia does not directly encourage the reduction of developing countries’ tax revenue. However, it may be indirectly involved in schemes, whereby companies strive to reduce the taxes payable in these countries.

The analysis of legal acts illustrated with hypothetical examples prompt the authors to conclude that several risk factors are present in Latvia, and when these factors interact, a contribution to international tax evasion is promoted. The risks include:

- low taxes for certain types of legal entities’ income from cross-border sources (dividends, interest payments and intellectual property), which are not related to cooperation agreements between the countries regarding the tax information exchange;
- weak control over the bank sector;
- ineffective policy in determining the actual beneficiaries;
- weak capacity in exposing fictitious enterprises.

The authors recommend several courses of action to prevent the involvement of Latvia in the international tax reduction schemes:
- To explain and implement the policy directions recommended by OECD to prevent international tax evasion.
- To support the EC Action Plan against tax fraud and tax evasion in the debates at the European Parliament and to promote its implementation in Latvia.
- To decline further tax reduction on cross-border transactions.
• To assess the prospects to discontinue the low cross-border tax regime attribution to the countries with which Latvia has no bilateral agreements on exchange of information regarding taxes until the bilateral agreements are concluded.
• To strengthen the capacity of State Revenue Service, Financial and Capital Market Commission and other law enforcement institutions to expose and prevent the cases of a tax evasion at the international level.
Methodology

The research includes analysis of both theoretical and empirical literature as well as educational materials in the field of tax justice as well as review of the newest policy initiatives from international organisations. Based on the risk indicators suggested by the TJN in respect to favourable environment for tax evasion, publically available information was gathered on presence of these indicators in Latvia. Authors of the research identified the following indicators:

- Latvia has low taxes for various types of income (holding company jurisdiction). This situation in combination with other circumstances may be used to avoid taxes on an international level.
- Supervision of banks that are servicing non-residents is problematical in Latvia.
- Latvia has low capabilities of investing and sentencing companies which are using tax heavens to pay fewer taxes in Latvia.
- Latvia has virtual office services which may be used as shell corporations making the determination of beneficial owner ineffective.
- Tax treaties that Latvia has entered into correspond to the OECD model.
- There is not a lot of explanatory information regarding tax evasion on international level in Latvian.

Based on this analysis, the authors thoroughly studied the legal framework of holding companies and modelled the possible ways of how this framework could be used for international tax evasion.

The following tasks were completed within the research:

- Information on international tax evasion was gathered and adapted into Latvian.
- Facts were gathered on the presence of risk factors in Latvia and Latvia’s policy for eliminating such risks.
- Detailed legal analysis of Latvian holding company legislation.
- Examples were modelled in respect to the possible schemes for tax evasion.
- Conclusions and recommendations for further policy action were drawn up.
Introduction of the Issue

Tax Policy and its Economic Goals

Tax policy is an instrument for achieving national economic goals. Furthermore, the national economic goal for the majority of countries is a sustainable development – a state is trying to improve wellbeing for all of its residents without restricting the capabilities of the following generations to increase their level of wellbeing as well. That is ensured by increasing or decreasing particular taxes, or, for example, by restricting inflation, increasing government revenue for performance of specific tasks, redistributing resources among wealthy and not so wealthy parts of the society, raising price of goods and services, for example, the ones causing harm to environment and health.

Taxes make up a significant part of the state revenue – in Latvia that is ¾ of the state budget revenue. If simplified, taxes may be divided into the income tax (from employment or capital), resource tax, and consumption tax.

In the best case scenario residents would be willing to pay into taxes that part of income which is left over after meeting the needs of themselves and their close ones in order to pay for such services which mostly may not be provided on individual basis – infrastructure maintenance, national security, public safety, social protection, education, and culture.

However, this system is not really working based on free will as both the taxpayers and the ones who are distributing taxes are people with their own needs and some certain level of self-regard. For some these needs are huge and trust to the state very low, and thus along with the desire to control one’s own life and lives of the people around comes also motivation to create one’s own world which includes systems or even complete infrastructures for savings and redistribution of these funds, security and social guarantees as well as education which are not interdependent with the state.

In its turn, officials in state administration and politicians tend to forget that they are working for the state residents and not for their institution (workplace) or private interests. If the goal is to fill up the state treasury at any cost, it is possible that the people may end up with less than it is needed to survive and maintain a certain quality of life. The state may try to save up and tax anything people do, whether it is sitting your grandchildren or picking berries in a forest. On the other hand, the most successful ones sometimes are required to pay for the state services more they are actually worth and cover for those whose income is lower.

If the interests of the state and the people are not balanced out, people are not willing to pay taxes. Many are disappointed in the state as an institution. There is a big proportion of grey economy. Many choose to live apart from the state by counting only on oneselves and their families or possibly a community by forming survival strategies similar to natural economy where the goods and services are traded without the presence of money. At the same time others who are often the most educated and talented tend to live internationally by searching the best circumstances for use of their talents and ideas.

The Letter and the Spirit of the Law
Tax policy is a tool used by every country to regulate economic and sometimes also political processes. States with a history of planned economy traditionally have a large proportion of employees and low number of employers or companies. In such case the state may decide that the corporate income tax is lower than the personal income tax, thus promoting both unemployed and employed to engage in entrepreneurship. For this reason the state may also offer various corporate tax reliefs that are applied to individual and small-size enterprises. In Latvia, such cases could be observed in respect to the tax rate for self-employed (5% of turnover) or Micro-enterprises. Unfavourable side effects of such policy include the restricted social guarantees for the self-employed and those employed by micro-enterprises as well as a desire of the existing enterprises to reduce their labour force expenses. If the labour taxes are fairly high, it stimulates businessmen to restructure their companies by making their workers as self-employed or separating some of their operations as micro-enterprises. Such actions, even though they are in conformity with the letter of the law, are opposite to the aim of the law and thus may be viewed as tax avoidance.

**International Aspects of Tax Policies**

Taxes also have an international dimension, taking into account that a favourable tax policy in one state may cause harm to taxation in another.\(^1\)

The modern taxation systems historically were created during times when certain countries were operating in a closed economy – majority of the personal and corporate income was generated and received within a single state. Also the business for the most part was carried out only internally. The state charged customs taxes and set rates for cross-border trade. After liberalisation of international trade and due to technological development the capital has become much more mobile. Also in respect to manufacturing and service provision it is possible to structure companies that are operating in multiple states and thus using the advantages, including, tax regimes. That is causing tax competition among states – the government is trying to offer cheaper and more convenient terms to investors for business development in the respective country.

We also have bear in mind the technological development and global context. On one hand technologies allow people to live like global citizens\(^2\) - to be virtually affiliated with several countries, work remotely from anywhere in the world, not to reside in a single country longer than the number of days allowed before a person is obligated to register as a taxpayer\(^3\), organise business in a way that the minimum required taxes are paid in some of the countries where this business is operating or registered as an enterprise.

However, this way of living is practiced only by a fraction of the global citizens, who have been born at the right place and in the right time, earned proper education, and endow the business gene as well as other skills and contacts. How do other people live? And are the richest global citizens responsible for poverty in the world? Are they the ones who not only create their worlds of happiness but also promoting poverty at the same time?

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\(^3\) For example, resident of Latvia becomes a tax resident if he/she is residing in Latvia at least 183 days per year.
Today a government has to compete for any taxpayer, both individuals and enterprises, as well as availability of capital for the blood circulation of economics – the investments. It is particularly important to the not so wealthy governments. There is inequality among governments just like among people – there are the wealthy, military powerful and developed states which can influence international treaties and regulations and then there are those which similarly to people lack resources, knowledge, and authority to become an equal member of negotiations.

Up till today, none of the countries have been able to form a national or international equality by finding answers to the following questions: How large should be the non-taxable minimum? What is the maximum amount that an individual may be required to pay for the services received from the state? Similarly, there has not been created a perfect tax system which would simultaneously eliminate inequality both on the national and international level.

International legal system (laws, agreements, and institutions) which protects the public interests has been formed to restrict the natural self-regard of people. There are also international non-governmental organisations which address issues that may not be resolved individually by each state. Due to personal interests, especially when a certain level of wealth and knowledge has been achieved, laws and agreements are often adjusted to match some personal needs both by engaging in lobbying and finding loopholes in the system in order to avoid declaration and taxation of the income.

### Inequality and Taxes

The 2015 study *Causes and Consequences of Income Inequality: A Global Perspective* from the International Monetary Fund concludes by analysing the Gini coefficient\(^5\) that around half of the world’s wealth (wealth is defined as the amount of financial resources and real estate properties at a disposal of a household after subtracting the debts of the household) are in hands of 1% of the people. This amount of wealth is 100 trillion US dollars and it is 65 times more than owned by the poorer half of the people. In the United States, 1% of the richest Americans own 1/3 of the total U.S. household wealth. In most of the countries, increase of the wealthiest for the richest 1% is attributed to decrease in wealth for the 90% of the poorest residents.\(^6\)

If full potential of the tax system is achieved along with good administration of state expenditure, it is possible to form healthcare systems that save lives, fund children education, and establish more stable, equal, democratic, and wealthier society. If the taxes are regressive and used as a form of punishment, it can boost poverty and inequality. Therefore, it is necessary to have just tax systems. An effective and just tax system plays even bigger role in the developing countries where there is high level of inequality and poverty as well as urgent lack of basic social services.


\(^5\) The Gini coefficient describes income inequality. It varies from 0 to 100. The Gini coefficient is 0 if there is an absolute income equality (e.g., all of the residents have equal income), but the closer it moves towards 100 the bigger is income inequality.

International Tax Evasion

Formation of the *Tax Justice Network*\(^7\) has been one of the attempts to promote balance between wealth and poverty. *The Tax Justice Network* (TJN)\(^8\) is an international network that was launched in 2003 in the United Kingdom as a limited liability company (Ltd.) with an aim to carry out research and form a public opinion in respect to the international tax policy. Founders of the network already had experience in researching non-tax jurisdictions or offshores and their impact on international economy, especially, in respect to the developing countries, as well as in launching projects to improve the situation. TJN are carrying out various projects by involving persons with the same view all around the world. The Tax Justice Together project unites two powerful NGOs – *Action Aid* and *Oxfam* as well as other NGOs from eight different countries, including, LAPAS (*the Latvian Platform for Development Cooperation*).

Work of TJN is devoted to analyse and research causes of poverty and they could be eliminated by improving taxation in respect to the wealthiest part of the society – in this case international or multinational enterprises, as well as by changing the unjust international tax policy that has been formed historically. Research suggests that in the current international tax policy the wealthiest and most powerful states have ensured more advantageous legal framework at the cost of developing countries.\(^9\)

TJN in its researches and publications discovers risk factors and various schemes that help international enterprise to structure their business in a way that the countries they are operating in not only do not receive tax payments, but also natural resources and labour force of these countries are used at an inadequately low price. Therefore, a *successful* internationally structured business increases poverty in the countries it is carried out. Since the problems have been arisen historically by states competing in a more or less liberal international market, the solutions should be searched for on an international level as well by agreeing on a policy which would eliminate the existing injustice. Debates on aggressive tax avoidance by forming international business structures that have been carried by the OECD and the EU over the past years have resulted in policy initiatives which could improve the situation.

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\(^7\) More information: http://www.taxjustice.net/ (Last accessed on 17.02.2016).
\(^9\) Ibid.
Factors Facilitating International Tax Avoidance

By tracing conditions that facilitate formation of such business structures, TJN outlines the following factors, the presence of which may facilitate tax avoidance:

- tax heavens;
- bubble companies;
- secrecy in finance and banking sector, trust (investment funds);
- tax reduction by states competing for attraction of investments;
- non-transparent reporting requirements for international companies from country to country;
- industries that support tax avoidance;
- unjust international tax treaties.

All of these conditions are described in more detail below.

Tax Heavens

Tax heavens are states or areas, the laws of which allow full or partial avoidance of tax payments which would have to be paid in the residence country\textsuperscript{10} or country of origin\textsuperscript{11} of the respective company. Tax havens are not only characterised by low tax rates for specific types of income, but also secrecy, particularly good conditions for non-resident companies, they do not exchange tax information with revenue services of other states, they provide legal secrecy in respect to enterprises founded in these states or areas (for example, about owners), besides enterprises founded in these states (areas) are not required to carry out any business activity there.\textsuperscript{12} Tax heavens are often called offshores, thus describing situation when a company is registered in a foreign country with tax regime and secrecy advantageous to its owners. By registering business in a tax heaven, a businessman may be fairly sure that information regarding his/her affiliation with the respective company, profits from the company as well as bank accounts or income will not reach his/her country of residence. Thus, this income will not be taxed in the country of the businessman’s residence.

One of the advantages for offshore companies is security against court decisions, meaning, U.S. court decisions as well as court orders from other countries are not recognised in offshore jurisdictions, protection against the consequences of divorce as such

\textsuperscript{10} The company residence country is the country where the company is registered (the authors’ explanation).

\textsuperscript{11} The country of the source of revenue is the country where the company performs economic operations providing profit (the authors’ explanation).

consequences of marriage or divorce are not recognised or may not be enforced in offshore jurisdictions, and absence of taxes as the trust funds (investment funds) or international enterprises founded in offshore jurisdictions are not subject to taxation. An offshore company also provides protection against bankruptcy as the credit claims are not recognised in offshore jurisdictions and in majority of the offshore jurisdictions there are no requirements for annual reports, owners can remain anonymous while maintaining full control over the offshore company by use of internet banking and other online services, besides offshore companies or trusts have no equity capital requirements. Historically, the modern tax heavens which begun their formation at the end of the 19th century may be organised in three groups – UK/British Empire-based tax havens, European tax regimes, and the rest of the tax heavens in South America and Africa. Reasons for their formation are mainly not related to the role these jurisdictions play in tax avoidance. After the end of the World War II, favourable tax regimes became a distinct developmental state strategy that could have evolved only in the context of a robust international system of statehood, respectful of the sovereign rights of states and within an integrated world market. Statistics suggest that tax havens have an extremely prominent role in the global financial system and have become an important instrument of tax evasion worldwide as well as constitute the single largest drain on developing countries’ economies. Today, the key issue regarding tax havens is their lack of transparency.

**Bubble Companies**

Low-tax or zero-tax areas offer virtual office service which may be provided by banks, accounting firms, law firms, or consulting firms. These services (usually) may not be used by companies with local operations. A virtual office supports a remote operation of a company – even from another country without any physical presence. For the most part standard services of virtual offices include:

- Rent of the legal and registration address based on which a company officially registers its operation. Often it is a prestigious address in the city centre.
- Mailing address and correspondence forwarding. All mail received at the legal address may be forwarded to the address specified by the customer.
- Virtual phone & fax number. When calling the office, the company's partners and customers talk to the secretary, who introduces him/herself as an employee of the company, accepts the call and leaves a note for the recipient or forwards the call to the predefined number. Another frequently offered option is the automatic call forwarding, while large customers are even provided with their own remote call centre.
- Rent of conference premises. In order to have a meeting with business partners, an entrepreneur may rent fully equipped conference premises at the address of the virtual office.

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• Sometimes it is also possible to acquire a nominee director. A nominee director is a person who agrees to be registered as a director of the company without any plans of engaging in commercial activities.\textsuperscript{15}

Virtual offices in the tax havens allow imitation of business activities in a country with low (or zero) corporate tax rates and thus allows saving the amounts that would be paid in taxes in the country of residence of the owner or in the country where the actual business activity is carried out.

**Secrecy in Finance and Banking Sector**

Operation of commercial banks is regulated by laws which prescribed that a bank may not disclose information regarding client’s account in the respective bank or any transactions performed therein without consent from the client. In some cases access to such information is denied to the local or international revenue services, as well as banking supervision or law enforcement institutions. It makes it difficult to trace who are the beneficial owners of companies and transactions made by such companies.\textsuperscript{16} One of banking services that include secrecy and anonymity is a trust. It is an individual service offered by the bank and it has several advantages:

- asset protection from third parties;
- confidentiality and security of transactions as they are made on behalf of the bank;
- often revenue and tax advantages if the respective state does not prescribe taxation of income arising from trusts.

When managing client’s funds, the bank is acting on its own behalf yet strictly in the interests of the client based on a trust management agreement and agreement for placement of funds entered into between the customer and the client. Besides, the trustor (client) is a full-fledged owner of these funds.\textsuperscript{17}

Secrecy of banks and existence of trusts hides the identity of the owner of funds and state institutions are not able to acquire information on the actual income of its resident in respect of which taxation might be avoided.

**Lower Tax Rates in Competition for Investments**

When seeking investments and taxpayers a state lowers its tax rates, thus sending out a signal to businesses about the possibilities to reduce expenses. Lowered corporate income tax rate is usually a domestic policy instrument for promotion of business. It may also work as a means of attracting foreign investments by establishing tax reliefs for non-residents. The studies show that since 1997 there has been a tendency of lowering corporate income tax rate in at least 70 countries.\textsuperscript{18} Such policy may result in a decrease in state tax revenue, thus lowering the standard of living for those groups of people, the well-

\textsuperscript{15} Summarised based on the service descriptions of the providers of the virtual office services found on the websites of service providers.


\textsuperscript{17} Summarised based on descriptions of bank services found on the websites.

being of which depends on the state budget – especially the disadvantaged residents. These states may be used to form companies related to international enterprises in order to lower their tax burden in respect to the business activities carried out (possibly) in the respective state. Especially high risk for use of such state is in the cases when non-residents have more advantageous tax regime than the domestic companies.

Non-transparent Reporting Requirements for International Companies by Countries

The existing accounting standards do not require international companies to provide public reports on their business activities by individual countries (from country to country). Therefore, state revenue service is not capable of tracking whether taxes paid in the respective state confirm to the level of income an international company has generated in this country and whether taxation has not been avoided.

Consultation Businesses Supporting Tax Avoidance

Provision of services for reduction or optimisation of taxes is not banned in all countries. The experts from TJN point out that the four largest international accounting firms – PricewaterhouseCoopers, Deloitte Touche Tohmatsu, KPMG, and Ernst & Youngi which have local offices in more than 130 jurisdictions – are very familiar with the accounting and legal regulations of each stat, thus being able to provide consultations on forming business structures that allow reducing the amounts paid in taxes. The same companies often provide consultations to governments in development of tax and accounting legislation, thus possibly creating a good environment for lowered tax rates in many states. In many places, tax optimisation and planning services are legal and demanded services.19

Unjust International Tax Treaties

Along with the development of international trade and manufacturing, states have to regulate which one of them has the right to tax specific income categories. It is in the state’s interest to receive tax payments from both residents (residents or enterprises of this state) and non-residents – foreigners that generate income in this state. It is usually in the interests of employees and companies to pay tax only in one country, to foresee how big will be the tax, and in general to have a simple, transparent, and predictable tax payment procedure. Tax may be imposed both in the state where income is generated and residence (registration) state of the company. In case of country of origin based tax, tax is imposed in the state where the income is generated. Residence based taxation means that tax is imposed in the state where the beneficiary is registered. Tax treaties divides rights of imposing taxes between the source and residence countries. A just treaty between economically equal countries should be symmetrical – it should provide an opportunity to withhold a part of the tax in the source country and a part of the tax in the residence country. Moreover, both of the countries shall have equal rights. Such treaties help avoiding double taxation.

Example 1. International Tax treaties

Tax treaty between Latvia and state X prescribes that source country has the right to withhold tax that does not reach 5%.

<table>
<thead>
<tr>
<th>LV</th>
<th>Royalties Latvia</th>
<th>State X</th>
<th>State X</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>University from Latvia invites an expert form State X to prepare and conduct lecture in Latvia (without exceeding 183 days). Source country.</td>
<td>Residence state of the businessman</td>
<td>Their rate 5%</td>
</tr>
<tr>
<td>15% - 5%</td>
<td>Residence state of the businessman</td>
<td>A professor from Latvia is invited to prepare and conduct a lecture in a university of State X. Source country.</td>
<td>5%</td>
</tr>
</tbody>
</table>

Another significant purpose for entering into a tax treaty is an agreement for information exchange regarding taxpayers. It prescribes that the state’s competent authorities (for example the State Revenue Service (SRS)) have the right to request information regarding business or banking activities of its resident by providing reasonable justification and the other state agrees to cooperate to provide such information.

However, not all of the tax treaties are fair. Sometimes and mostly developing countries are “forced” to accept unfavourable terms. If one of the parties to a treaty is poor, it is anticipated that investors from such country would not benefit from a symmetrical treaty. By analysing tax treaties, experts from the TJN have ascertained that in cases when majority of the rights to charge taxes is given to the residence country, almost all of the taxes are mostly charged by the wealthier states.20

Facts, Statistics, and Public Attitude in Respect to International Tax Evasion

Facts

Experts from the TJN have estimated that if a business is formed by using inequality in tax regimes of various states and unfair intergovernmental tax treaties, the international

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companies reduce the amount to be paid in taxes by **3 trillion U.S. dollars per year**, besides around one fourth of these losses are occurring in the European Union.\(^{21}\) OECD has ascertained that it is difficult to acquire data on whether taxes are being paid in accordance with the legal requirements; however, they have developed six indicators proving that tax evasion is real and this trend is expanding. OECD research suggests that **from 100 to 240 trillion U.S. dollars are lost by governments due to evasion of corporate income tax.** To monitor this process, states are encouraged to acquire and analyse adjusted tax information.\(^{22}\)

**Example 2. Transfer Mispricing\(^{23}\)**

In 2013 the Kenyan government prosecuted Karuturi Global Ltd, the world’s biggest producer of cut roses, for using transfer mispricing to avoid paying nearly 11 million U.S. dollars (about 8 million EUR) in corporate income tax in Kenya. This was the first time an African government had taken a large multinational company to court for transfer mispricing through a fully public process. Karuturi Global Ltd had sold roses to a subsidiary in Dubai for one-tenth of the market price, before the subsidiary in Dubai sold them on to Europe at the real market price. Because of this, nine-tenths of the profit from the roses grown in Kenya ended up in Dubai, which is a tax haven.

**Tax Evasion Scandals in the European Union**

In 2015, the European Network on Debt and Development (Eurodad) organisation carried out a research which also summarises scandals caused by tax evasion.\(^{24}\)

- In November and December 2014, LuzLeaks documentation exposed tax decision in relation to hundreds of international companies in Luxembourg.\(^{25}\)
- In February 2015, SwissLeaks published financial information in relation to more than 100,000 clients of Swiss banks.\(^{26}\)
- In February 2015, McDonald’s took the spotlight by being featured in a report on tax payments made by the fast-food giant. The report gives an evidence that a subsidiary company of McDonalds in Luxemburg with only 13 employees have recorded a turnover of more than 3.7 billion EUR from 2009 to 2013 requiring to pay only 16 million EUR in taxes.\(^{27}\)

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\(^{23}\) Coulby, H., Collinson, H. Tax Justice Toolkit. Understanding Tax and Development. STOP Tax Dodging. 2013, Page 15. Available: [https://drive.google.com/file/d/0B7QbEYhMFLH1Tl1rN2U1MmIsOG8/view](https://drive.google.com/file/d/0B7QbEYhMFLH1Tl1rN2U1MmIsOG8/view) (Last accessed on 17.02.2016).


• In June 2015, Walmart made the headlines after being exposed by a detailed report on company’s tax policy. The report shows that Walmart has branches in Ireland, Netherlands, Luxembourg, Spain, Cyprus, and Switzerland even though there are no Walmart stores in these countries. The report describes tax savings generated thanks to such European subsidiary companies.\(^{28}\)

• Two individual researches on mining from 2015 showed that the Netherlands was used to reduce tax payments in Malawi and Greece.\(^{29}\)

**Public Attitude**

Eurodad research suggests that regardless of the lawfulness tax avoidance practiced by international corporations often is carried out on such a large scale that a lot of people see it as amoral and undesirable. Experts have summarised data from researches done in 2014 and 2015\(^{30}\) and conclude that, for example a survey carried in Great Britain in 2014 suggested that 85% of the adults believed that corporate tax avoidance was morally unacceptable even if carried out in accordance with the law while 70% responded the same way when a similar survey was given to people in Ireland in 2015.\(^{31}\)

Other data gathered by Eurodad:

50.4% of the surveyed residents from nine EU member states believe that taxation of the rich and subsidising of the poor is an essential characteristic of democracy. In the first question, respondents had to answer whether they agreed or disagreed with the statement that an essential characteristic of democracy was *government taxing the rich and subsidising the poor* where 10 meant that it was essential and 1 that it was not at all essential. 50.4% of the surveyed people valued this statement with 7-10. This question was answered by the EU residents in: Cyprus, Estonia, Germany, Netherlands, Poland, Romania, Slovenia, Spain, and Sweden. The other number (87.4%) is made up on residents who answered that *cheating on taxis was never justifiable even if there was such an opportunity*. These answers were measured on a scale from 0-10 where 0-4 meant that the respondents agreed that *it was never justifiable*.\(^{32}\)

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From 2006 – 2013, 133 protests out of 488 (27%) in relation to the Economic Justice and Austerity all around the world were organised to ask for tax justice. 33

78% of the residents from 18 EU member states agree that the government should require companies to publish the real names of all their shareholders and owners. Respondents were asked to value to what extent they agreed that the government should require companies to publish the real names of all their shareholders and owners. 78% responded strongly agree and tend to agree. The survey covered the following countries: Austria, Belgium, Bulgaria, Czech Republic, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Netherlands, Poland, Portugal, Romania, Spain, Sweden, and Great Britain. 34

The omnibus survey carried out for the TJN with a sample of at least 1000 adults selected in order to acquire representative data on residents in 16 European countries provide the following thoughts:35

77% residents in Europe agree that legislation needs to be amended to ensure that companies and wealthy individuals could not use tax havens for reducing their payable taxes [in the relevant country where the survey is performed]. 50% of surveyed persons in Europe do not agree that the current legislation successfully ensures that big international companies would pay their taxes in global countries. More than a half of population in Europe (54%) agree that public services in poor countries are deteriorating due to the taxation regimes arranged by big international companies for their benefit. 50% of surveyed persons in Europe consider that practices by big international companies (by using locations where taxes are low) impact the gap between wealthy and poor countries. More than a half of the European population (56%) think that poor countries would have more money for fighting poverty if we changed tax conditions on the global scale.


Schemes and Other Legal and Illegal Measures for International Tax Avoidance

In the course of studying the practice of international companies, TJN have described several ways how international companies can legally (however, just literally complying with the law and not its intention) or illegally evade taxes.

Use of Specific Schemes Created by Themselves, Accountants and Lawyers for Avoiding Taxes

Audit companies and law firms often offer tax optimisation services promising their customers to manage the global tax burden and to solve business issues in a legally correct and efficient manner. If a company invests in various countries or in various projects and manages its financial functions globally, these firms offer advice regarding all the international tax planning aspects, including creation of an efficient tax structure, selection of a favourable financing mechanism and profit repatriation solutions that would reduce the tax burden on the company group level.

Example 3. Use of tax havens

In reality an international company sells and delivers your banana directly to a supermarket which sells the banana to the consumer. On the paper this way is not that simple as it passes one or several tax havens:

• A company in the country that produces banana sells banana to a sister company in a tax haven at a very low price, which is actually equal to the costs of producing the banana.
• In the result it looks like no profit has been gained and therefore no tax is payable in the country where banana was produced.
• The sister company in the tax haven then sells the banana to a sister company in another country at a very high prices using the justification that extremely expensive financial services were used in the tax haven.
• The income obtained from production of banana implemented by the company in the tax haven is very high, however, the company pays a very little tax or does not pay anything at all because tax rates in the “haven” are very low or even equal to zero.

TJN experts consider that most risks in this area are related to the operation of international audit companies because they are both well aware of laws in all the countries where they operate and often are involved in drafting such laws. The European Commission report of January 2016 provides a detailed description and analysis of seven international schemes where the European Union Member States are involved.\footnote{Ramboll Management Consulting and Corit Advisory. Study on structures of aggressive tax planning and indicators. Taxation papers. Working paper N. 61, 2015. Available: http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/\textit{economic analysis/tax_papers/taxation_paper_61.pdf} (Last accessed on 17.02.2016).} The study describes the following “schemes” if an international company operates in three countries:

- an offshore loan scheme (3 countries);
- a hybrid loan scheme (3 countries);
- a hybrid company scheme (2 countries);
- an interest free loan scheme (4 countries);
- a patent post-box scheme (3 countries);
- a two level intellectual property scheme (5 countries);
- an intellectual property and costs agreement (3 countries).

Since 2012 the OECD has been compiling information regarding various tax evasion schemes in order to enable countries to exchange this information and to plan relevant measures for eliminating schemes. The data base contains information about more than 400 different schemes.\footnote{OECD. Co-operation and exchange of information on aggressive tax planning and indicators. 2013. Available: http://www.oecd.org/ctp/aggressive/co-operation-and-exchange-of-information-on-atp.htm (Last accessed on 17.02.2016).}

Besides such complicated accounting and organisations schemes, TJN presents some more ways how influential international companies achieve a more favourable taxation regime for themselves.

**Requesting Tax Reliefs in Negotiations with the Country where Economic Activities are Performed**

Company representatives may engage in lobbying or event corrupt the governments of the countries which compete for investment and want the company to come to the country by persuading it to provide more favourable tax payment regimes than provided for by the legislation of the relevant country on the basis of an agreement. Thus, a company not only benefits from a possibility not to pay taxes, but also obtains an advantage in comparison to local companies, as its business costs are lower. In non-democratic countries such agreements are not available to public. Although these methods are correct from the legal point of view, they do not release from responsibility, because in tax law, different from other areas of law, the economic essence of a transaction is often more important than its legal form.
Issue of Fraudulent Invoices to Other Companies in Order to Distort the Obtained Profit and Taxes Paid for this Profit

When there are related companies, it is possible to present expenses for services or goods which have not been purchased prior to tax assessment. Provision of certain services is hard to prove, for example, received consultations.

Setting of Incorrect Transfer Prices for Goods and Services to Daughter Companies within the Same International Company

Related companies have a possibility to present higher expenses for services or goods which are available on the market at much lower prices. In this way the obtained profit and payable taxes can be distorted.

Example 4. Setting of incorrect transfer prices II

A draft auditor’s report which was recently made public contained the information that the huge international company Glencore (now – Glencore Xystrata) had exported copper from Zambia to Switzerland (at least, according to documents) at a very low price amounting to one fourth of the market price. When copper was sold at its true price, the profit could have stayed in Switzerland where it would be taxed by a low tax or there would be not tax at all. Glencore rejected performance of any illegal actions.

In a study commissioned by the organisation Christian Aid it was found out that according to documents:

• 36,000 kg Nigerian coffee were exported to the USA at the price of 69 cents per kilo at the time when the global coffee price was 2.35 US dollars per kilo.
• A cargo of hair dryers was exported to Nigeria where the mean price per hair dryer was 3800 USA, however, the market price of the same model was 25.35 US dollars.

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Problems Related to the European Union Countries

From the economic point of view, the European Union is a project aimed at establishing a single market with the participation of sovereign countries. According to A. Smith’s theory of economy, which is the basis of this project, when there are free flows of goods, services, finance and labour, the wealth of all the countries will grow. Labour will flow to the countries where it is possible to earn more, thus employers and governments will compete by increasing wages and improving the social environment. Investment, in turn, will flow to the countries where there is better investment and business environment, therefore, countries will improve it and in the result residents of all the countries will benefit. Countries compete on this market by both their natural advantages and also by the advantages created by these countries in the result of their economic policy, including taxation policy. However, the economic selfishness, as incorporated in the policy based on the competition between countries, has a range of political and social side-effects. For example, in structuring international business possibilities are created to avoid payment of taxes in the countries where economic activities are performed by placing the company structures in the countries where the taxation policy is more favourable for the entrepreneur. In the European Union, taxation policy is the sovereign responsibility of each country, and upon joining the European Union a range of countries were accepted by agreeing on special taxation regimes in their jurisdictions.

In 2015 a number of scandals revealed companies which used deficiencies of taxation systems for bypassing taxes. Poorer countries cover the losses caused by the global taxation system, although they have not established this system. A large part of scandals revealed during the last year are directly related with the EU and its Member States. In 2015 in the study carried out by the organisation Eurodad42 each country is benchmarked vs the other EU Member States based on the following four important criteria: how fair tax agreements of this country with developing countries are; to what extent this country is prepared to terminate the operation of anonymous, fictitious companies and trusts; the presence of the state support for improving the transparency of economic actions and tax payments of international corporations; the state’s attitude towards involving poorer countries in negotiations when global tax standards are discussed.

The report concludes as follows: Generally, the EU taxation system provides possibilities to reduce costs caused by taxes for international corporations. Although adjustments have been made and certain deficiencies have been eliminated, the complicated and disfunctional EU system which regulates the income tax resolutions, agreements, mail-box companies and specific enterprise tax regimes has not been modified.

In some aspects related with contradicting specific taxation regimes which are applicable to income from intellectual property (patent box), the harmful policy in Europe has been even growing.

The protection mechanisms against “harmful taxation practice” implemented by governments are viewed by the authors of the study as only partially efficient, and they are not available to most developing countries. In the EU there is still competition regarding which country will provide the most favourable taxation regime for investing to international companies.

EU citizens, Members of Parliament and journalists or state institutions of developing countries do not have sufficient information about how much taxes international corporations pay and where they perform economic activities. In the study it is concluded that the measures proposed until now, in particular, the “transparency” as it is understood now, actually provide that tax administrations in developed countries will exchange information about international corporations by using complicated and secret procedures. This information will not be publicly available.

It should be viewed positively that information accessibility regarding the actual owners of companies operating in EU countries is improved, because increasingly more countries introduce publicly fully or partially accessible state registers about the actual company owners (true beneficiaries). Unfortunately, new mechanisms emerge for hiding the company ownership, for example, new type trusts.

The information which was made public is the main source of publicly accessible information regarding the tax avoidance implemented by international corporations. Unfortunately, this information costs a lot to involved persons because reporters and journalists who discovered the breaches by international corporations are being accused and could spend many years in prison. The stories of these “heroes of tax fairness” present a harsh illustration of broader social costs caused by the existing secret and non-transparent enterprise income tax system.

The authors of the report conclude that more than 100 developing countries are not involved in decision making processes when decisions are made regarding global tax standards and regulations which impact everybody.

In 2015 developing countries started fighting for global tax democracy by demonstrating particular activity in the Financing for Development Conference (FfD) in Addis Ababa. However, the EU position towards the requirements defined by developing countries was strict and it played the main role by blocking proposals regarding the establishment of a truly global taxation system. None of the EU Member States disputed this position and in the result the adoption of decisions regarding global taxation standards and regulations still remains a “closed club” only accessible for rich countries.
Recommendations of International Organisations for Preventing Tax Avoidance

*Tax Justice Network* considers that in order to achieve positive change and improvement of the situation the following actions are needed:

On the global level – it should be achieved that the European Union and the EU Member States would support organisation of a global forum by making negotiations related to the international corporate tax reform fair and involving all the countries impacted by the taxation policy there with equal rights.

On the European level – more transparent accounting rules should be introduced obliging big companies in any sector to publish their financial information (daughter/ sister companies, number of employees, turnover, profit and information about paid taxes), which would allow tax collection authorities making international companies to pay taxes at the places where the actual economic operations are performed.

On the national level – the political and legal goals important for fair taxation policy should be defended by introducing changes in the political system on the national level that would support the movements of activists and public information campaigns. However, it is the particular goal on the national level to encourage the European Union Member States to grant rights to developing countries to tax international companies by introducing actual reforms that would be related with concluded tax agreements.\(^43\)

By responding to the researchers’ conclusions, proposals of international non-governmental organisations and the public pressure, also inter-governmental institutions have started political initiatives for solving the situation. This is demonstrated in G20 declarations, \(^44\) projects of the Organisation for Economic Cooperation and Development, \(^45\) the EU action plans \(^46\) and government notifications.

**OECD Initiatives**

In October 2015 the Organisation for Economic Cooperation and Development agreed on measures related to reduction of the taxable income base and profit

\(^43\) See the TJN project description available at [www.lapas.lv](http://www.lapas.lv) (Last accessed on 17.02.2016).


shifting (Base Erosion and Profit Shifting) or BEPS. This initiative is aimed at a new international approach to taxation of companies by reducing the possibilities for avoidance and providing for the entitlement of countries to tax income in the country of origin. The initiative is criticized by non-governmental organisations involved in cooperation, including the TJN, because developing countries which suffer most from the existing taxation policy were not involved in its development.

BEPS refers to the taxation planning strategies allowing to use deficiencies in laws for shifting profit to countries or territories with low tax rates without performing economic operations in these countries. Thus, companies and their owners pay a low income tax or do not pay any tax at all. The initiative in the fight against this phenomenon is particularly important for developing countries whose tax revenue depend on the enterprise income tax to a large extent.

Directions of Action for Preventing Tax Evasion
The initiative provides for the following directions of action:

- Elimination of the consequences caused by the impact of the digital economy upon payment of taxes. The OECD proposes regulations and their implementation mechanisms in order to collect the Value Added Tax in the country where the customer is located in cross-border transactions. Taking into account the flexibility of this field, it has been decided to continue following-up development processes and to propose new initiatives as necessary.
- Neutralisation of non-compliances between local tax laws and international tax agreements in order to prevent double NON-taxation.
- Strengthening of the control over foreign companies controlled by residents in order to ensure that the income obtained in a country is not diverted to a foreign company. In particular, this applies to intellectual property and digital transactions. In this way the unfair setting of transfer prices would be prevented with particular success.
- Movement towards equal taxation of interest and other financial payment income. In this way mutual loans and financial services within the group would be reduced which are used for reducing taxes. This policy should be implemented in close cooperation between countries by complying with competition conditions.
- Agreeing on the methodology that would allow establishing whether substantial economic activity is carried out in a country with a low tax regime. In cases when no investment is required for implementing activity, like it is in the case of intellectual property, the company expenses in the relevant country should be defined as the applicable criterion (“nexus” approach). The measure also provides for inter-governmental information exchange.
- Prevention of the use of international agreements contrary to their aims, including elimination of exerting pressure upon countries in order to force them to reduce taxes. The direction of action defines the ways how non-residents use inter-governmental agreements. The OECD also proposes amendments in the sample

agreement to ensure that it does not contradict local laws aimed at tax avoidance. The Preamble of the sample agreement stipulates that the agreement may not be used for tax avoidance. It also contains specific conditions that have to be complied with in concluding tax agreement with low-tax or tax-free countries or territories.

- **Prevention of artificial avoidance of registration of the resident status.** Tax agreements usually stipulate that the country taxes a company if it has a permanent representative office in this country, thus the definition of tax residence or representation in agreements is of particular importance. The sample agreement contains a recommended definition which does not allow avoiding registration of a representative office if economic activities are carried out in the country and does not allow artificial splitting of a company.

- **Two directions of action are aimed at setting fair transfer prices,** by complying with the so referred arm’s length or fair competition principle. These directions include setting of the price of “intangible” services which are difficult to assess, as well as economically irrational activities. The OECD will also propose methodologies according to which developing countries can evaluate fair transfer prices for implementing tax assessment in future.

- **Monitoring of tax avoidance.** Within this direction of action the OECD concludes that there are obstacles preventing obtaining necessary data, however, six BEPS indicators have been developed and if these are satisfied this serves as an evidence of tax avoidance and allows evaluating whether it is growing. According to the monitoring results, countries incur annual loss of 100 to 240 trillion US dollars as unpaid enterprise income tax. In order to monitor these processes countries will be invited to collect and analyse updated tax information.

- **Requirements to tax payers to disclose the ways of how they avoid payment of taxes.** This information can help tax administrations in other countries to prevent the operation of similar “schemes” by evaluating risks, as well as by carrying out audits and implementing legal amendments. Cooperation between tax administrations is also important in this regard.

- **Improvement of documentation of transfer prices in order to support the work of services and not to impose excessive burden upon entrepreneurs.** The standardised three-tier approach also includes the minimum **standard for Country by Country Reporting (CBCR),** by offering a common sample. The reporting system would consist of three documents. The master file would reflect the company’s global business and the transfer price policy of this company. The second document is the transfer price policy and practice country by country. Third, it is planned to require CBCR which would reveal the income obtained in each jurisdiction, profit before taxes, paid taxes and other information. CBCR will be prepared by the mother company and it should be automatically disseminated to the tax administrations of all the involved countries. The implementation plan of this condition provides that the relevant information should be provided in due time and that countries will maintain confidentiality of these reports. This would allow tax administrations to identify the cases of the transfer price risk. This approach will also reduce the burden of international companies caused by the necessity to submit reports in numerous jurisdictions according to different conditions.

- **Development of more efficient inter-governmental tax dispute resolution mechanisms.**

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The transfer price should comply with the price at which an equal product or service can be bought on the market.
• Development of an international agreement on tax issues. The OECD plans to develop this document and to open it for signing in 2016. 90 countries participate in development of the agreement. The OECD has also undertaken to monitor implementation of the above steps and the impact of each direction of action. The OECD also declares that in 2016 it will create a new negotiating platform where all the interested countries and jurisdictions will be able to participate on equal terms.

Directions of Action for Elimination of Poverty

Within another direction of action, i.e. minimisation of inequality inside countries, the OECD defines criteria regarding desirable taxation policies. The OECD has compiled the following taxation policy options for countries where there is high tax inequality:

- Reduction of social contributions and the amount of taxes withheld from wages for employees with low wages, thus encouraging them to maintain their employment and developing skills for further employment.
- Elimination or reduction of broad tax reliefs, tax credits and exceptions because they grant a disproportional high benefit to residents with high income.
- Application of the income tax to all types of income, including additional benefits provided by employers (for example, health insurance, use of a car), interest payments, income from shares.
- Use of the biggest part of tax revenue for regular payments for immovable property.
- Revision of the usefulness and efficiency of property and heritage taxes.
- Evaluation of the introduction of a moderately increasing capital growth tax by applying it personally to the owner, by balancing the highest capital growth and personal income tax rates.
- Increase of transparency and international cooperation on taxation legislation in order to minimise the spread of the practice when persons and companies who should pay high taxes structure their finance in such a way that they can use the countries which offer the lowest tax rates and also tax optimisation.
- Expansion of the income tax base in order to minimise possibilities of tax evasion and reduce the flexibility of taxable income.
- Promotion of the policy that improves transparency and tax payment, including by attaining the support by the OECD countries to this policy in order to ensure automated tax information exchange between revenue services.

Implementation of the directions of action proposed by the OECD depends to a large extent upon the willingness of the current and (in case of Latvia) future member states and the legal compliance by entrepreneurs.

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Solutions Proposed by the European Union

Tax debate has been complicated in Europe during recent years. Several scandalous discoveries regarding tax evasion by multinational companies and the role played by several European countries in this regard were keeping tax issues in the focus of public attention during the last year. Some of scandals are related to tax evasion involving illegal actions and several other discoveries are related to tax avoidance.  

The Action Policy Proposed by the European Commission

In January 2016 the European Commission published new policy initiatives aimed at fighting tax avoidance. The initiatives are based on the study analysing seven international schemes used in practice and providing information about the set of conditions providing for the establishment of each scheme in each of the involved countries. The study analyses all the EU Member States laws by looking if there are any of the risk conditions present in the particular Member State.

The new European Commission proposals include directions of action which as a set could prevent aggressive tax evasion, would increase transparency among member states and would ensure more fair competition within the single market:

- Provision of legally binding measures for stopping the most popular methods used by companies for tax evasion.
- Recommendations to member states for preventing violations of tax agreements.
- A proposal to the member states to share tax information about international companies operating in the European Union.
- Measures promoting good international tax governance.
- A new EU process wherein the countries outside the EU which refuse to engage in fair cooperation will be identified.

Planned further actions by the European Commission:

- Efficient taxation of companies by ensuring that companies pay taxes in the country where economic activities are performed (the country of origin of income).
- The Commission proposes for review by the Parliament the Anti Tax Avoidance Directive providing for legally binding provisions aimed at elimination of the most frequent schemes used for tax avoidance.

The EC has also developed recommendations regarding tax agreements in order to ensure that these agreements, in compliance with the EU law, are not used as a possibility for tax avoidance.

Improvement of the transparency of tax payment by international companies on the country level by providing a separate report per country of operation.

The Commission proposes to review the Directive on Administrative Cooperation. According to the proposed wording, countries will have to exchange tax (and related) information on international companies country by country. Thus, the countries will have information for identification of eventual risks and planning of tax audits.

The issue regarding publicly accessible information on tax payments by international companies country by country is reviewed separately. It is planned to complete the impact assessment of this initiative in spring 2016.

Ensuring of fair economic policy. Tax avoidance and competition of countries by setting the lowest tax rates is a global issue which has to be solved also outside the EU framework. If the EU Member States implement measures which would attain changes in the present situation and impact transparency, as well as tax competition similar steps would have to be taken also by other countries, or the EU would face an unfavourable competition situation.

A step in the above referred direction is the Commission Communication on an External Strategy for Effective Taxation. It is aimed at strengthening cooperation with external partners in implementing fair taxation policy.

The European Commission reports that the initiatives commenced in 2015 regarding promotion of transparency of tax payments and reform of enterprise taxes have provided the first results; for example, during a period of seven months governments have agreed on the tax transparency proposal. The Commission also undertakes to continue working on an important measure, i.e. introduction of the common consolidated corporate tax base.

Further steps envisaged by the EC include submission of legislative proposals for consultations to the Parliament and Council in order to achieve approval of these proposals. Also the proposal regarding tax agreements (Commission Recommendation on the implementation of measures against tax treaty abuse) that will have to be taken into account by the Member States in revising tax treaties needs to be approved.

Moreover, the Member States also have to agree on the new foreign policy strategy and about as fast as possible implementation of this strategy following its approval.

The European Union also imposes an obligation to establish a central register of true beneficiaries and to make it accessible to everybody who may have a legitimate interest to identify company owners.

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The European Parliament Position

In the study by Eurodad it was found out that, although there are several groups of Eurosceptics in the European Parliament, the majority of the MP’s still support more involvement of the EU in tax issues. The EP has urged the European Commission several times to adopt a more active position as regards tax fairness, including by listening to various Commissioners in the Special Commission on Tax Rulings in 2015. The EP has been also supporting the proposal regarding the Common Consolidated Corporate Tax Base (CCCTB) regarding the tax coordination in the whole EU for a long time and confirmed this position in 2015. In the Parliament Report on Taxes 2015 it is also emphasised that “coordinated action on the EU level is required for moving towards application of transparency standards to third countries.”

However, the EP also criticises the current tax coordination process in the European Union, in particular, the closed Action Code Group for taxation of business activities operating under the Council of Europe. In 2015 the EP asked to revise the group mandate “in order to improve efficiency of its work and to attain considerable results, for example, by introducing the obligation to publish tax reliefs and subsidies to companies”, and it also asked the group to ensure more transparency by publishing “the report about the extent countries comply with the recommendations provided by the group in the Six Months Progress Report to Ministers of Finance.” Implementation of these proposals would also improving the work of the Action Code, which is actually inefficient at present.

Support by the European Parliament to Global Solutions

The EP confirmed its strict support to establishment of an inter-governmental UN structure which would be responsible for taxes. This was communicated in the Communication on Taxes 2015 as well as in the Tax Report by the Commission of Development. In the Report by the Commission of Development the EP “urges the EU and Member States to ensure that the UN Tax Committee is transformed into a try inter-governmental institution, equipped with better tools and sufficient additional resources by including it in the structure of the UN Economics and Social Council, and

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58 Ibid. Line 37.


ensuring that all countries can participate in development of the global taxation policy and reforms on equal terms. As the recommendation was published a month prior to the Financing for Development Conference (FfD) in Addisabeb, this was an important signal. However, similar to many EP progressive recommendations regarding taxes, this proposal is not binding for the EU Member States and countries chose to ignore it.

Infographics 1.
Fair EU taxation system, scandals and LuxLeaks

Review of Action Policies of Individual EU Member States

The authors of the study carried out by Eurodad, by comparing 15 EU countries, arrive to the following conclusions regarding the action policy of these countries for preventing tax avoidance:

France, which had asked for public access to information regarding taxes paid by international corporations, is no longer asking for tax transparency. Contrary to promises to encourage “transparency”, increasingly more EU countries now suggest strict confidentiality in order to hide the tax amounts paid by international corporations.

Denmark and Slovenia have a leading role as regards transparency of the true owners of companies. These countries have not only stated that they introduce public registers of company ownership, but they have also decided to restrict (or in case of Slovenia, have avoided the temptation to introduce) unclear structures, for example, trusts, which can provide alternatives for hiding ownership. However, several EU countries, including, in particular, Luxemburg and Germany still continue offering various possibilities for hiding liability for eventual money laundering. Among 15 countries included in the report, Spain is definitely the most aggressive representative in negotiations on tax agreements, and it has succeeded to reduce tax rates of developing countries by 5.4 percentage points on average by using its tax agreements with developing countries. Great Britain and France have had the leading role in blocking the requirement by developing countries to grant the participation rights in negotiations when decisions are adopted regarding global taxation standards and terms.


64 Ibid.

65 Ibid.

66 Ibid.

67 Ibid.
Open Government Partnership as a Possible Forum for Policy Solutions

Another international forum where international tax avoidance is discussed is the Open Government Partnership. This is a multilateral initiative of governments and non-governmental organisations established under UN and where the non-governmental sector and governments of countries work in cooperation in order to achieve change in the internal policies of these countries. The initiative provides that governments jointly with NGO’s develop two-year action plans for reforms that encourage open governance, including transparency in state administration, including tax payment issues. Keeping true beneficiaries secret which allows tax avoidance is among the issues that can be discussed and solved in these action plans, receiving international support. The commitment to promote the disclosure of true beneficiaries has been included in their action plans by Great Britain, Norway and Ukraine.

Latvia

The present analysis is aimed at finding out whether and to what extent the Latvian tax policy and other conditions in this country contribute to international tax avoidance.

Introduction. The Personal Income Tax (PIT) and Enterprise Income Tax (EIT) Policy in Latvia

No long-term tax policy strategy has been defined in Latvia. Several impact factors are reflected in the tax system: the state’s attempts to fill the state treasury, pressure by local interest groups (the Association of Commercial Banks, the Foreign Investors Council, the Chamber of Trade and Commerce, the Latvian Traders Association should be mentioned as most influential interest groups), the recent impact by international lenders, the international obligations of Latvia as an EU Member State and the willingness to be accepted in the “club” of developed countries by becoming a member state of the Organisation for Economic Co-operation and Development. The National Development Plan is a policy planning document which indirectly defines the tax policy goals and the national economy goals provided therein include promotion of business and reduction of the income inequality. While the present study is developed, the Ministry of Economy is working on drafting the Tax Policy Guidelines. The pressure by interest groups in Latvia have resulted in attempts to create favourable conditions for international tax optimisation, however, such attempts have not always succeeded.

In Latvia tax revenue accounts for approximately ¾ of the total budget revenue. The other budget revenue consists of non-tax revenue and revenue from foreign financial aid. Employment taxes account for 50% of the total tax revenue (50.3%). Consumption tax revenue account for one third of the total tax revenue (34.9%). The proportional share of capital tax income in the total tax revenue was 8.2% in 2014 and resource taxes accounted for 6.6% of tax revenue.

Infographics 2
Budget of Latvia 2016

69 Within the framework of the present study an interview with Māra Simane, a representative of the Cross-Sectoral Coordination Centre, was carried out, December 30, 2015.


Comparative perspective regarding the proportional share of tax revenue in the central budget in EU countries.

- The EU mean proportion of tax revenue to GDP has increased a little – from 38.6% in 2004 to 39.6% in 2012. In seven countries: Denmark, Sweden, Belgium, France, Finland, Austria and Italy, the tax revenue/GDP proportion was highest.

- Romania, Lithuania, Latvia and Ireland in both years were among the six countries with the lowest index. Estonia and Portugal which were among the six countries with the lowest index in 2004 have been replaced by Bulgaria and Slovakia.

- Tax systems in the EU are still very different: for example, revenue from capital taxes ranges from 2.1% of the GDP in Lithuania to 10% and above in Great Britain, France, Italy and Luxemburg.

- The number of different personal income tax rates varies from one in Hungary and Bulgaria (non-taxable minimum income is not applied in these countries, i.e. the personal income tax rate is totally flat) to seven and minimum 19 in Luxemburg;

- The share of property tax within the total tax revenue ranges from below 1% in Estonia, Austria, Czech Republic, Greece and Luxemburg to 3.4% in Great Britain and 2.4% in France.

In Latvia there have been attempts to increase the progressivity of the income tax, introduction of a few capital taxes has been successful, and as from 2016 the transition to a differentiated non-taxable minimum income for natural entities has been implemented. A solidarity tax has been introduced.

Infographics 3
Differentiated non-taxable minimum income

Risk factors in Latvia – a View from Outside

International Advertisement

Tax optimisation service providers both in Latvia and on the international scale include Latvia among the countries where it is profitable to establish related companies thanks to its low taxes and bilateral tax agreements. For example, the company Lawtaxcompany ranks Latvia along with the countries like Hong Kong, British Virgin Islands, Panama, Bulgaria and others. Two following Directives are referred to as an additional condition for favourable profit transfer within EU: – the EU Parents-Subsidiary Directive and the Interest and Royalties Directive allowing transfer of dividends, interest payments and intellectual

property payments between EU Member States and Switzerland without withholding any tax. A Swiss company offers to establish a company in Latvia (also in Switzerland, Dubai, Singapore, Hong Kong and Cayman Islands). On the other hand, there is also an offer to Latvian entrepreneurs to establish companies in tax havens and to reduce the tax burden in this way. The practitioners of the field think that in Latvia these are mainly established by metal processing companies and consultation firms whose largest share of income consists of export and transactions outside EU. However, the market of this kind of service is believed to be insignificant in Latvia – the biggest markets are believed to be Ukraine and Russia. In Latvia these services are offered by approximately 20 entrepreneurs, for example, Constanta, Taxlink.

Comparison with EU Countries
In a comparative study about the European Union countries it has been concluded that 13 of the 17 risk indicators defined in the study are present in Latvia. This is also the mean index in all the EU Member States. In Latvia totally 15% to 30% income tax is withheld from companies registered in any of the countries included in the currently valid “black list”. The conditions that contribute to the use of Latvia for tax evasion are as follows based on the assessment by the authors of the present study:

• Latvia does not verify true beneficiaries, by applying dividend, royalty or interest income withholding tax reliefs when the income beneficiaries declare that they are from a country outside this list.

• The tax amount for interest income is not related with the tax regime in the residence country. The possibility to reduce taxes applied to interest income along with the situation when, in applying these reliefs, the true beneficiary is not established, allows establishing the scheme for avoiding taxes.

• On the other hand, this tax avoidance is limited because in Latvia the provisions regarding insufficient capitalisation (thin capitalisation), as well as restrictions regarding reliefs for taxation of interest have been introduced.

• In Latvia there is no regulation regarding the companies controlled by the Latvian residents abroad.

• In Latvia there are no laws eliminating the non-compliance regarding the foreign tax regime.

(mismatch in the foreign tax treatment) for the Latvian partners and the Latvian


81 The Law on Personal Income Tax provides that the income received from foreign companies shall be treated as taxable income – the authors’ explanation.
companies. There are no such provisions in the taxation systems of almost any EU Member States.

• According to the assessment by the authors of the present study, Latvia offers too much relief regarding dividend income – 0% tax shall be paid. Except when a daughter company is registered in any of the 49 blacklisted countries, it is not verified whether the daughter company has used tax reliefs regarding payable dividends. Latvia has not introduced the amendments in the Parent/Subsidiary Directive as yet, moreover, the officials surveyed by the authors of the present study consider that the definitions of dividends and interest payments in the Latvian laws achieve the purpose of these amendments.

• The issue whether a tax will be withheld from dividend equivalents, for example, capital reduction payments, should be studied further.

• A triple amount of expenses for research and development may be deducted from the income tax base. If the results of such research have been sold during a period of three years after the last expenses, the clause of increase of taxes is applied.

Global Comparison

Latvia cooperates with other countries regarding exchange of its residents’ tax information. In the comparative analysis carried out in 2015 by TJN, Latvia was ranked 59th within the comparison of 92 countries. The study analysed 15 secrecy criteria and provided conclusions regarding the following areas:

1. True beneficiaries:
   - bank secrecy towards competent authorities has been partially eliminated;
   - Latvia partially restricts the formation of trusts and private funds;
   - Latvia partially collects and maintains information about true beneficiaries.

2. Transparency of company operations:
   - Latvia does not require companies to make data about the company shareholders public;
   - Latvia does not require companies to make their annual reports public;
   - in some cases Latvia requires reports of related companies per countries.

3. Legal regulation of tax and financial flows:
   - Latvia does not require its residents paying withholding tax for non-residents to notify the competent authorities of these countries regarding tax payments in Latvia;
   - The competent authorities of Latvia have means for efficient analysis of the information related with payment of taxes and collecting taxes;
   - The Latvian tax credit system partially fulfils the condition regarding avoidance of granting unilateral tax credits;
   - Latvia partially allows the so referred cell companies and trusts with jurisdiction change provisions where under certain conditions authorities can be easily transferred from one person to another located in another jurisdiction (trusts with flee clauses).

4. International standards and cooperation:

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Latvia has partially introduced international standards for preventing money laundering;

Latvia participates in the automated information exchange system within the framework of bilateral agreements at full scope;

As in May 2015, Latvia had concluded minimum 53 agreements regarding tax information exchange and they comply with the OECD basic agreement standards;

Latvia has ratified the five most important conventions providing for financial transparency;

Latvia partially cooperates with other countries in cases of money laundering and other criminal cases.

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83 Information about Latvia, Tax Justice Network. Financial Secrecy Index – 2015 Results. Available:
Conditions Contributing to Involvement of Latvia in International Tax “Optimisation” Schemes

Tax Reform – Latvia as a Low Tax Country for Certain Types of Income

At the end of 2010 the Cabinet of Ministers (CoM) assigned the task of developing the policy for taxation of offshore transactions to the Ministry of Finance. The Ministry of Finance prepared the information report “On taxation of offshore transactions and the possibilities to strengthen this procedure”. It not only offered solutions for taxation of offshore transactions, but also contained alternative proposals. The Ministry of Finance proposed to assess the possibility of commencing and gradual implementation of the taxation policy that would encourage the placement of corporate regional headquarters of company groups, corporate financial management centres of company groups, company group copyright centres, holding companies in Latvia.

According to the estimations by the Ministry of Finance, implementation of proposed solutions would result in establishment of a sufficiently attractive taxation regime compliant with the EU requirements in Latvia that would also attract entrepreneurs of other Member States and encourage them to carry out their operation by using companies founded in Latvia and would also reduce the interest of Latvian entrepreneurs to use artificial structures in low-tax and tax-free countries or territories. The Cabinet of Ministers decided to promote the proposed amendments for reduction of taxes for certain types of corporate income (amendments to the Law on Enterprise Income Tax), at the same time providing for amendments regarding controlled foreign companies (amendments to the Law on Personal Income Tax) and true beneficiaries (amendments to the Commercial Law).

Based on the above proposal, at the end of 2011 the CoM adopted and the Saeima /the Parliament of Latvia/ approved a number of amendments to laws discouraging Latvian entrepreneurs to carry out transactions with companies registered in tax havens. On one hand, the measures provided for taxation of such transactions, on the other hand, they reduced a number of taxes for transactions in Latvia. According to the law amendments the following income shall not be taxed:

- dividends paid by a company – a resident of Latvia, to a non-resident which is not a resident of the EU/ EEA MS or an offshore country (as from 2013);
- dividends received by a company – a resident of Latvia, from a non-resident if the dividend payer is a resident of a country which is not a low-tax or tax-free country or territory (as from 2013);
- interest payments paid by a company – a resident of Latvia, to a non-resident which is not a resident of the EU/ EEA MS or an offshore country or territory if payments are made after 31 December 2013;

84 Minutes of the Meeting of the Cabinet of Ministers of the Republic of Latvia No. 35, Riga, June 7, 2011.
• payments for intellectual property paid by a company – a resident of Latvia, to a non-resident which is not a resident of the EU/EEA MS or a low-tax or tax-free country or territory if payments are made after 31 December 2013.

In addition to the above, the draft law provides that as from 2013 income or loss from alienation of shares of stock and shares are not taken into account in assessing the taxpayer’s taxable income, except the income if a capital company whose shares were purchased is a resident of a country or territory which has been declared a low-tax or tax-free country or territory based on the Cabinet Regulations.\(^{85}\)

The new procedure is particularly favourable for the investors who establish mother companies in Latvia and who have daughter companies in countries which are not offshores. 15% enterprise income tax has been applied in Latvia to the dividends paid to offshores as from 2012. Dividends paid to capital companies registered in other countries are not taxed. By this policy Latvia extended the favourable taxation regime regarding cross-border dividends, interest payments and intellectual properties to all countries, except low-tax and tax-free countries.

Although the reform discouraged tax avoidance by establishing related companies in offshores, it creates another risk by creating an encouragement to use Latvia as a country where it is profitable to establish a fictitious company and to avoid taxes.

The low capital taxes (in combination with other factors) as a risk for eventual establishment of schemes are also referred to by the authors of the European Union Study on structures of aggressive tax planning and indicators.\(^{86}\) Low capital taxes also contradict the OECD recommendations for minimising poverty.\(^{87}\)

In Latvia there have been attempts to even further strengthen this tax regime favourable for international business. In autumn 2015 the association „Tēvzemei un Brīvībai“ /For Fatherland and Freedom/ submitted the proposal by the Latvian Chamber of Trade and Commerce for reduction of the Enterprise Income Tax by 85% (from 15% to 2.25%) for trade companies who carry out their economic operations outside the European Union and only use the banking infrastructure for settlements in Latvia. In 2015 the Ministry of Finance was against the attempts to make the tax regime even more favourable for non-residents who only use financial and trade intermediary services in Latvia. The Taxation Policy Sub-Commission of the Saeima /the Parliament of Latvia/ decided not to promote this proposal by leaving it for further discussion. In its criticism of this proposal, the Ministry of Finance to a large extent uses the argumentation based on the OECD standards and the willingness of Latvia to join this organisation, the EU countries support policy, as well as refers to a high risk of money laundering and eventual risk of reduction of the credit rating of Latvia and sustainable investment.\(^{88}\)

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The government approved on 11 February 2016 in its Declaration of Intended Activities has set the goals which are directly related to solving the problem – minimisation of the shadow economy, revision of the tax and duties system (including reduction of inequality), as well as transfer of the tax burden from labour to income from capital and capital growth, consumption, immovable property and use of natural resources. 89

**Holding Companies in Latvia – Detailed Legal Tax Regulation and Possible Schemes**

Traditionally, a capital company whose main function is holding of the majority of shares in another company is referred to as a holding company. Holding companies may be further divided in to categories depending on whether they only hold shares in their daughter companies and do not perform economic operations or their own behalf or do not implement management functions, or holding companies who are actively involved in performance of daily business operations and perform management functions. Regulatory enactments of Latvia do not provide a definition or categories of a holding company. The only definition which could be referred to a holding company can be found in the Law “On Enterprise Income Tax”, 90 providing the definition of a mother company – this is a capital company whose participation share in another business company exceeds 50 per cent or which holds the majority of votes in another business company. However, within the context of tax regulation, the percentage of hold shares of daughter companies is not essential. The regulatory enactments of Latvia do not stipulate any requirements or restrictions regarding the economic operations of a holding company.

Still, it is possible to speak about a favourable or less favourable environment for establishing holdings and performance of operations. From the point of view of tax regulation, for the operation of holdings the application of the Enterprise Income Tax (EIT) to the income of holdings is most essential – the rate of the EIT and the possibility to treat certain expenses as business expenses, application of tax reliefs to dividends paid by daughter companies, as well as dividends paid to shareholders, intellectual property, interest income from large loans for financing the holding group companies, as well as income from capital growth. As holdings often have cross-border aspects in their operations, also the range of concluded tax conventions and the tax regime applicable to non-residents is important.

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If a holding has management functions, also labour taxes in relation to highly paid employees are important. The above and other aspects have been taken into account in Latvia to a higher or lesser extent since 2013 when the relevant amendments to the EIT Law entered into force moving towards a tax regime which is favourable for the operation of holdings, in order to encourage attraction and maintenance of investment in Latvia. In the European Commission document “Action Plan on Corporate Taxation” 2015 it is reported that the main channels of profit shifting to the countries where there are lower tax rates include obtaining of loans and interest payments, transfer prices and intellectual property.

The Enterprise Income Tax Rate, Taxable Income

The standard Enterprise Income Tax rate in Latvia is 15% and this is among the lowest rates of this tax among the European Union countries. 92 Per se, this should be viewed as a favourable aspect for investments. Latvian companies (residents) and permanent representative offices should pay the tax based on the so referred principle of residence, i.e. all the income obtained during a taxation year is taxable in Latvia in compliance with the Law on Enterprise Income Tax (hereinafter – EIT Law). As permanent representative offices pay the tax based on the principle of residence, sometimes, when the EIT regime is less favourable in the other country, mother companies implement structures aimed at artificial avoidance of registration of a permanent representative office, for example, by concluding an agreement with a commissioner/agent for performing the company operations, by artificial division of agreements by using the exceptions provided for by Clause 5.4 of the tax conventions. It is planned to restrict such operations in future by including relevant actions in Paragraph 7 of the Action Plan of the Organisation for Economic Cooperation and Development against base erosion and profit shifting 93 94.

The entities of the non-resident status (for example, daughter companies of a holding company) pay the tax based on the principle of the source of obtaining income, i.e. the tax is only applied to particular types of income provided for in the EIT Law. The entity disbursing the income, i.e. the Latvian resident or the permanent representative office of the non-resident, is responsible for withholding the tax from a non-resident at the moment of disbursing the relevant income, therefore it is often referred to by using the term “withholding tax”.

As regards the income of non-residents it is important to take into account that usually the taxation is also regulated by inter-governmental tax conventions which often provide for lower

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94 See more: Vilnis, E. “Mērķis ierobežot mākslīgu izvairīšanos no pastāvīgas pārstāvniecības” [Aiming at limiting artificial avoidance of a permanent establishment, Bilance, 01.02.2016. No.3 (375)].
withholding tax rates. Latvia has concluded a high number of tax conventions, i.e. with 58 countries.

The existence of the micro-enterprise tax regime in Latvia providing for application of a special reduced tax rate should be mentioned as a specific aspect. In 2016 this rate is set to 9% of the total turnover of a micro-enterprise amounting up to 100,000.00 euros per year: both for the turnover up to 7,000.00 euros and for the turnover from 7,000.01 euros to 100,000.00 euros; however, for the latter category the micro-enterprise tax rate is set to 12% starting from the fourth taxation year of business operations.

The micro-enterprise tax includes the following:

- the mandatory state social insurance contributions, the personal income tax and the business risk state duty for the employees of a micro-enterprise;
- the enterprise income tax if the micro-enterprise complies with the features of an enterprise tax payer;
- the personal income tax of the owner of the micro-enterprise for the share of the business income of the micro-enterprise.

Although a holding company as such will most probably not qualify for the status of a micro-enterprise, the above conditions provide for a possibility of reduction of taxes in relation to daughter companies or employment of employees. Still, it has to be noted that this tax was introduced as a temporary mechanism, therefore, its validity is restricted and is revised every year. There is also a special tax rate for operation in special economic zones or free ports providing for the entitlement to receive up to 85% tax relief (immovable property and property tax reliefs).

Considerable tax reliefs are provided for initial long-term investments. Section 17² of the EIT Law stipulates that a company is entitled to apply a tax relief of 25% for initial long-term investment made within a supported investment project if the investment amounts from 10 to 50 million euros and a tax relief of 15% if the investment amounts from 50 to 100 million euros.

Example 5. Tax reduction on the inter-country level I

This example reflects a simple and legal scheme allowing reduction of the tax amount payable in Ukraine. This scheme is theoretical to a large extent because the saved amount of the payable tax is comparatively low. In reality this scheme could be continued and expanded, thus achieving an even higher amount of tax optimisation.

Goals: (1) to avoid the provisions restricting unfair transactions between related companies (regarding definition of transfer prices); (2) to use the provisions of the inter-governmental tax agreements regarding payments to non-residents.


<table>
<thead>
<tr>
<th>Steps</th>
<th>Explanation</th>
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</thead>
<tbody>
<tr>
<td>The company UKR operates in Ukraine.</td>
<td>The enterprise profit tax in Ukraine amounts to 18%. Latvia and Ukraine have concluded an agreement on double taxation and prevention of tax evasion.</td>
</tr>
<tr>
<td>The company LAT is established in Latvia.</td>
<td>The founders of LAT are residents of Latvia, the company address is in Latvia. LAT management is related with UKR management, however, their relationship on the company control and management level cannot be proven.</td>
</tr>
<tr>
<td>LAT cooperates with UKR.</td>
<td>LAT is not the permanent representative office of UKR, therefore, as regards cooperation between both companies: (1) the provisions regarding establishment of transfer prices are not applicable; (2) Clause 7 of the Convention of the Government of the Republic of Latvia and the Government of Ukraine for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital is not applicable to them – the enterprise income tax is not imposed on the profit gained by UKR in LAT, and LAT may deduct the expenses related with the participation of UKR related persons in provision of LAT services from its income.</td>
</tr>
<tr>
<td>UKR purchases from LAT a PR service and a brand the costs of which are very close to the profit gained by UKR in Ukraine</td>
<td>UKR reduces its income taxable by the profit tax in Ukraine by this amount.</td>
</tr>
<tr>
<td>LAT hires residents of Ukraine for performance of a PR service and pays author’s fees to them</td>
<td>Residents of Ukraine stay in Latvia less than 183 during a period of 12 months and this means that the reference regarding the use of the permanent base in Latvia is not applicable to them, therefore, the author’s fee tax is applicable to them as independent providers of individual services – non-residents. Latvia taxes the author’s fees payable to the Ukrainian residents at a rate of 10%. The Ukrainian residents reduce their tax by 8% (because the profit tax payable in Ukraine would be 18%).</td>
</tr>
</tbody>
</table>

Enterprise Income Tax Reliefs for Income from Alienation of Shares of Stock

As from January 2013 income from alienation of shares are no longer taken into account in assessing the taxable income of a capital company. Moreover, for purpose of the Law on Enterprise Income Tax, “shares” include not only the shares of stock of a joint stock company, but also shares, capital shares or any other basis providing the entitlement to participate in distribution of a company profit. This means that the company income obtained from sale of shares/ shares of stock are not taxed by applying the Enterprise Income Tax, however, the taxable income should be increased by the loss incurred from alienation of shares of stock/ shares. The above provisions are applicable regarding alienation of shares of stock of capital companies registered both in Latvia and also abroad. An exception refers to the cases when the shares of stock of a capital company which is a resident of a country or a territory which, based on the provisions of regulatory enactments, is declared a low-tax or tax-free country or territory. For example, if a Latvian Limited Liability Company owns shares of stock in a company registered in Barbados (in compliance with the Cabinet Regulations 98 Barbados is included in the list of countries to be regarded as low-tax or tax-free countries and territories, hereinafter referred to as “Offshore territories”), and the Latvian Limited Liability Company alienates these shares, its taxable income may not be reduced accordingly by the income obtained in the result of alienation of these shares and the income will be taken into account in assessing the Enterprise Income Tax.

An exception will also apply to the cases when a non-resident alienates the shares of stock of a legal entity (registered either in Latvia or abroad) where more than 50% of assets consist of immovable property located in Latvia – in this case the 2% Enterprise Income Tax is withheld and the withholding should be done by the payer. 99 Theoretically, it is possible that a transaction of alienation of these shares of stock is carried out between non-residents (in this case also the legal entity whose shares of stock are alienated is registered abroad), however, the withholding tax of the transaction should be voluntarily paid in Latvia by the payer withholding 2% of the payment amount.

Dividends

Dividends paid by a Latvian resident to another Latvian resident (a legal entity) or received from another Latvian resident are not subject to withholding tax or enterprise income tax. The tax, however, is applied if the recipient of dividends is a private individual, in which case the dividends received are subject to the personal income tax of 10%. Thus, whenever dividends reach the end destination – a private individual, they are taxed at 10% regardless of whether the recipient is a resident or a non-resident. In addition, in many countries, such as Germany or the neighbouring country Lithuania, the tax on dividends received by a private individual is higher. Accordingly, a non-resident recipient of dividends should expect that his or her dividends may be subject to income tax both in Latvia and in his or her country of residence. Since 1 January 2014, withholding tax does not apply any more to dividends paid to non-residents, with the exception of Offshore Area residents.

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Accordingly, when paying dividends to offshore residents (legal entities or private individuals), a withholding tax of 15% is applied, while extraordinary dividends are subject to a withholding tax of 30% (Sections 3(8), 3(8') and 3(8'') of the Law on Enterprise Income Tax).

Extraordinary dividends are a relatively recent development in the Latvian commercial law. This means that dividends can be paid more often than once a year and there is no need to wait for the preparation and approval of the report for the full tax year to be able to decide on the payment of dividends to shareholders. Amendments to the Commercial Law, which allow for paying extraordinary dividends, entered into force on 17 February 2014, and corresponding changes were introduced in the tax law. According to the amendments to the Commercial Law, the payment of extraordinary dividends is subject to a number of conditions, such as the disbursement of extraordinary dividends must be provided for in the company’s articles of association, and extraordinary dividends may be paid at a rate which does not exceed 85% of the company’s profit obtained in the relevant accounting period.

When implementing the payment of extraordinary dividends, account should be taken of the risks associated with the possible consequences of imprudent distribution of non-existent profit. In the event that the general accounting year of the company is closed with a loss, the paid extraordinary dividends will be classified as expenses that are not related to business activity, by applying a coefficient of 1.5. Consequently, the company’s taxable income, on which the enterprise income tax is payable, will increase significantly. In view of the above, the payment of extraordinary dividends requires caution and realistic calculation of the possible profit performance of the company in order to avoid a situation where imprudent payment of dividends throughout the year leads to the close of the general accounting year with a loss and an increased amount of taxable income.

Interest Payments

Interest payments paid by a holding company to another private individual or legal entity (resident or non-resident, with the exception of an Offshore Area resident) are not subject to tax deductions, while payments to the Offshore Areas are subject to a withholding tax of 15%. The same condition also applies to payments for intellectual property: a withholding tax of 15% applies only to payments to the Offshore Areas (Section 3(8'') of the Law on Enterprise Income Tax). In turn, received interest payments and payments for intellectual property rights are considered to be the company’s taxable income on which the enterprise income tax is calculated accordingly.

Example 6. Tax reduction through intellectual property

Objective: (1) to decrease the amount subject to the enterprise income tax in Latvia through intellectual property regimes and bogus intellectual property; (2) to decrease the amount subject to the enterprise income tax in Ukraine through the Cypriot intellectual property regime.

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<tr>
<th>Steps</th>
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<tbody>
<tr>
<td>The multinational holding company HOLUKR founded in Ukraine establishes the company CYPCO in Cyprus and transfers all the intellectual property rights to it.</td>
<td>Ukraine and Cyprus have signed the agreement on avoidance of double taxation and the prevention of fiscal evasion. The existing intellectual property rights are transferred at market prices.</td>
</tr>
<tr>
<td>CYPCO licences the intellectual property rights to LATCO, a subsidiary of HOLUKR in Latvia.</td>
<td></td>
</tr>
<tr>
<td>LATCO pays royalties to CYPCO for the use of intellectual property.</td>
<td>The amount paid as royalties is equivalent to the amount of the company’s profit. According to the Latvian legislation, royalties paid to non-residents (who are EU residents) are not subject to tax. At the same time, LATCO reduces its taxable income. According to the Cypriot legislation, the profit from intellectual property is not subject to tax.</td>
</tr>
<tr>
<td>CYPCO pays dividends to HOLUKR.</td>
<td>The dividends paid are not subject to tax in Cyprus. According to the agreement on the avoidance of double taxation and the prevention of fiscal evasion signed between Ukraine and Cyprus, dividends paid may be taxed at 5% in Ukraine.</td>
</tr>
</tbody>
</table>

This example is based on the European Commission’s study on structures of aggressive tax planning and indicators.  

**Related Companies and Transfer Pricing**

The definition of related companies and specific provisions in regard to transactions with related companies are set forth in the Law on Enterprise Income Tax (Section 1(3)(12)). The most significant condition in regard to the conclusion of transactions with related companies is a requirement for such transactions to be concluded at market prices. The so-called *arm’s length principle* is used to determine the market price. This means that the price of the goods or services received by the company from a related company may not be higher than the price that would be applicable in the market.

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situation between unrelated companies, and, vice versa, the price of the goods and services supplied by the company to a related company may not be lower than the market price of the goods or services.

If this condition is not met, the company’s taxable income may be increased by the difference between the payment made/received and the corresponding market price. In cases where the company’s net sales in the accounting year exceed 1,430,000 euros and the transaction amount is higher than 14,300 euros, the law obliges the company that concludes transactions with related companies to prepare and keep for 5 years documentation justifying the determination of the market price and its application to transactions with related parties. This documentation must be submitted to the State Revenue Service within a month after the request. If the information is not provided, the State Revenue Service will determine the market price based on the information available and adjust the company’s taxable income accordingly and the tax amount due and payable on that income.

In preparing the documentation for the determination and application of the market price (transfer pricing documentation), account should be taken of the methods listed in the Regulations of the Cabinet of Ministers No.556 “Regulations on the Application of Provisions of the Law on Enterprise Income Tax” that can be used by a company to determine the market price of a particular transaction: the comparable uncontrolled price method, the resale price method, and the cost plus method. If these methods are not sufficient to determine the market price of the transaction, it is possible to use the transactional net margin method, and the profit split method. In order to facilitate the determination of market prices according to the above methods, the company can use the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as an aid. It should be noted that the transfer pricing issues are included in the already mentioned OECD’s BEPS Action Plan, which may introduce changes in the application of the market price principle in the future.

If the company is planning to conclude a deal with persons related to foreign countries, and the estimated amounts of these transactions are relatively large, it is eligible to propose entering into a preliminary agreement with the State Revenue Service regarding the determination of the market price (value) for a particular transaction or a particular type of transaction, if the value of the transaction carried out or planned with a related foreign person exceeds 1,430,000 euros per year. An advantage of such an agreement is that the market price cannot be subsequently adjusted or revised as a result of the State Revenue Service’s audit, provided that the company has complied with the conditions of the agreement and has not made any changes in the business activities which would be contrary to the conditions of the agreement. Such an agreement may be concluded for a fee, which is 7,114 euros.

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Transactions with related parties *per se* are transactions with private individuals or legal entities that are located, have been established or have been registered in one of the Offshore Areas. Therefore, when concluding transactions with the companies registered in such countries or areas, it is important to keep in mind the requirements of compliance with transfer pricing. At the same time, the law provides for an exception where payments to the Offshore Areas are not subject to withholding tax, that is, payments for supplied goods and purchased publicly traded securities of the European Union or the European Economic Area, provided that these goods and securities are purchased at market prices.

**Example 7. Avoiding transfer pricing rules**

The example describes a very simplified scheme used to avoid transfer pricing rules. In reality, this scheme would be more complicated, involving a number of related and legally unrelated companies in various countries of residence. Objective: (1) to avoid profit and income tax payments in Ethiopia, Latvia, and Russia, by using loopholes in the cooperation of trans-national tax authorities, and in the exchange of information; (2) to avoid transfer pricing rules.

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>The company RUSHO is operating in Russia.</td>
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</tr>
<tr>
<td>The company LAHO owned by the same resident of Russia is established in Latvia.</td>
<td></td>
</tr>
<tr>
<td>LAHO establishes its subsidiary in Ethiopia, ETHI.</td>
<td>There is no agreement on the avoidance of double taxation and the prevention of fiscal evasion signed between Latvia and Ethiopia, and Ethiopia is not considered a low-tax or zero-tax country.</td>
</tr>
<tr>
<td>RUSHO purchases the coffee produced in Ethiopia from ETHIC at cost price.</td>
<td>Since RUSHO and ETHI are not legally related companies, they are not subject to transfer pricing rules, and RUSHO may determine the purchase price, which is lower than the market value. Russia has signed an agreement on the avoidance of double taxation with Ethiopia.</td>
</tr>
<tr>
<td>LAHO further purchases the coffee from RUSHO, calculating the intermediation profit margin as low as possible.</td>
<td></td>
</tr>
<tr>
<td>LAHO sells the coffee further on the Baltic and Eastern European markets for the full price.</td>
<td>The company’s total profit is concentrated in Latvia, not Russia or Ethiopia.</td>
</tr>
<tr>
<td>LAHO pays the profit as dividends to the Russian residents.</td>
<td>According to the agreement on the avoidance of double taxation and the prevention of fiscal evasion signed between Latvia and Russia, the income tax on dividends is 5%.</td>
</tr>
</tbody>
</table>
Alternatively, LAHO could purchase coffee beans directly from ETHI, without intermediaries, thus increasing profits for LAHO and avoiding disclosure of profit to RUSHO. In this case, in order to safeguard against the non-compliance with the transfer pricing rules, ETHI would disclose that coffee beans have been purchased at prices which comply with the transfer pricing rules. To ensure the concentration of profits in Latvia, not Ethiopia, ETHI would get a loan from LAHO, for which it would pay monthly interest at the price difference between the cost price of the coffee and the market price. LAHO would pay income taxes on the interest payments received. Although the enterprise income tax rate in Latvia is 15% (in Russia it is 20%), the rate can be reduced up to 6.5% using one of the 20 tax reliefs or a combination thereof.

**Example 8. Artificially created internal financing costs**

**Objective:** To reduce the amount of tax liability through artificially created internal financing costs and bypassing the transfer pricing rules.

<table>
<thead>
<tr>
<th>Steps</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>A multinational company which is registered in Ukraine establishes a subsidiary in Estonia (ESTCO), a subsidiary in Belarus (BELCO) and a subsidiary in Latvia (LATCO).</td>
<td>Although the loan is interest-free, ESTCO is subject to transfer pricing rules; therefore, the company can reduce the amount chargeable with enterprise income tax, classifying the hypothetical interest payments as expenses. BELCO, in turn, does not report the interest payments received to the Belarusian tax authorities, thus not increasing the amount of tax liability.</td>
</tr>
<tr>
<td>ESTCO takes an interest-free loan from BELCO.</td>
<td>The transaction between LATCO and ESTCO is carried out in accordance with the transfer pricing rules.</td>
</tr>
<tr>
<td>ESTCO further grants the funds received from BELCO as an interest bearing loan to LATCO, a Latvian company of the group.</td>
<td>According to the Estonian law, the interest payments received are not subject to tax.</td>
</tr>
<tr>
<td>LATCO makes interest payments to ESTCO that can be deducted from the income subject to income tax.</td>
<td>According to the Estonian law, the dividends paid are not subject to tax.</td>
</tr>
<tr>
<td>ESTCO pays the profit gained from LATCO’s interest payments as dividends.</td>
<td></td>
</tr>
</tbody>
</table>

**Rules on Controlled Foreign Companies and Limitations to the Deductibility of Interest**

There are no rules in Latvia that would limit the operation of controlled foreign corporations (normally, such rules provide for imposing the enterprise income tax on
the subsidiaries’ income which is not subject to tax in low-tax countries).\textsuperscript{107}

If an entrepreneur has more than one company in their portfolio, a situation may arise when one of the companies requires additional funds, while other companies operate at a profit. Then the entrepreneur can decide whether to withdraw dividends from one of the companies and lend them to another, or to use the available funds to finance another company in the group, or expand the group by establishing a new company. In any case, this creates a need to lend the money earned and charge interest on the loan. The interest expenses would constitute expenditure and reduce the borrower’s taxable base.

However, the interest deduction limitations within the framework of a holding company in Latvia are quite strict: the taxable income is increased by interest payments in proportion to the extent to which the average amount of debt obligations in the taxation period (in respect of which the interest payments are calculated) exceeds the amount, which is equal to four times the amount of equity reflected in the taxpayer’s annual accounts (at the beginning of the taxation period), which is reduced by the conversion of long-term deposits into reserves and other reserves, which have not been created as a result of the division of profits. Debt obligations are subject to the annual weighted average interest rate set forth by the Bank of Latvia and granted to domestic non-financial companies in the taxation period that must be multiplied by a factor of 1.57. The amount of interest payments included in the operating expenses may not exceed the actually calculated amount of interest payments. This means that the income subject to the enterprise income tax must be increased by the adjusted amount of interest payments. If the taxable income has to be increased on the basis of the above two conditions at the same time, the bigger of the taxable income amounts must be chosen.\textsuperscript{108}

\textit{Example 9. Reduction of the amount of income subject to enterprise income tax in Latvia}

This example shows a very simplified scheme which is nevertheless complicated in Latvia by the above-mentioned strict thin capitalization rules. Objective: to reduce the amount of income subject to enterprise income tax in Latvia.

<table>
<thead>
<tr>
<th>Steps</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The multinational company MULTILI is registered in the Principality of Liechtenstein.</td>
<td>Liechtenstein is included in the Latvian list of low-tax or zero-tax countries and territories.</td>
</tr>
<tr>
<td>It owns the representative office/subsidiary CYPR in Cyprus.</td>
<td>Cypriot legislation does not impose the enterprise income tax on the companies whose owners are registered in other countries.</td>
</tr>
<tr>
<td>MULTILI establishes the holding company HOLDLA with small capital in Latvia.</td>
<td></td>
</tr>
</tbody>
</table>

\textsuperscript{107} Latvia has only introduced measures for imposing the personal income tax on private individuals, provided that the person has income from a company established in an offshore jurisdiction (explanation by the authors).

CYPR grants an interest bearing loan to HOLDLA.

HOLDLA makes interest payments to CYPR.

HOLDLA has the opportunity to reduce the amount of tax liability on income (if the debt-to-equity ratio is not higher than 4:1). Cyprus is not included in the list of zero-tax and low-tax countries. Latvia does not check the beneficial owner (and therefore does not detect the relation with Liechtenstein’s company).

CYPR does not pay tax on the income from interest payments.

CYPR pays dividends without taxing them. The profits of Liechtenstein’s residents are not taxed.

To make this example more complex, the amount optimised in regard to taxes can be increased: HOLDLA can establish another holding company in another EU country and grant an interest bearing loan to it, which will be used to acquire the company X. The new holding company and X are combined in a tax group. The loan interest payments of the new holding company are subtracted from the taxable income amount of the company X. Consequently, HOLDLA receives income – interest payments from the new holding, but it does not pay taxes on that amount, because it makes interest payments to CYPR (this scheme is described in the European Commission’s study on structures of aggressive tax planning and indicators109).

**Expenses on Research and Development (Section 66 of the Law on Enterprise Income Tax)**

Although the task of holding companies in most cases is to manage stocks or shares in other companies, they often tend to carry out also other activities, such as serving as the head office or the performer of research and development functions. A new tax incentive aimed at promoting research and development was introduced in Latvia on 1 July 2014, which allows a significant reduction of the income subject to the enterprise income tax by expenses on research and development (the eligible expenses are calculated in triple amount), provided that the restrictions set forth in the Law on Enterprise Income Tax have been met: the expenses are directly attributable to labour costs and purchase of research services from specialised scientific institutions for the development of business activity.

*Example 10. Special provisions for investment in research and development*

Objective: To reduce the amount of the international income of a group of companies subject to the income/profit tax, using the special provisions for investment in research and development.

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### Steps

| The holding company LATHOLD registered in Latvia is the head office of a group of companies and performs the research and development function by making investment in research and development. | According to the Latvian legislation, LATHOLD may reduce the income subject to the enterprise income tax by the sum invested in research and development in triple amount. |
| LATHOLD establishes the company CYPRCO in Cyprus which is to engage in production and sales outside Latvia. |  |
| CYPRCO establishes the company NETHCO in the Netherlands and the company MOLDCO in Moldova. |  |
| NETHCO undertakes to produce and sell the products of LATHOLD group outside Latvia and assumes all business risks. |  |
| CYPRCO also transfers the rights of use of the intellectual property to NETHCO. | NETCO pays royalties to CYPRCO, which are not taxed. |
| NETHCO contracts MOLDCO to produce the goods, but the goods are the property of NETHCO. | Although the core activities (creation of value) mainly take place in Moldova, MOLDCO only pays taxes on labour to the Moldovan authorities. MOLDCO is owned by CYPRCO, and the company’s profit is channelled to Cyprus through the management and administration services. Profits of subsidiaries are not taxed in Cyprus. Moldova and Cyprus have signed the agreement on avoidance of double taxation and the prevention of fiscal evasion. |
| NETHCO sells the goods in cooperation with marketing companies in other countries. |  |
| CYPRCO pays the profit as dividends to LATHOLD. | The dividends paid are not taxed in Cyprus. |

This example is based on the European Commission’s study on structures of aggressive tax planning and indicators.\(^\text{110}\)

### Attracting Highly Qualified Staff; Management and Advisory Services

Labour costs are high in Latvia: the standard state social insurance contribution rate is 34.09%, while the personal income tax is 23%. Previously, the ceiling of social security contributions for higher-paid employees was mentioned as a comparative

advantage. On 1 January 2016, the solidarity tax\textsuperscript{111} was introduced, effectively removing the social insurance contribution ceiling and introducing adjustments in the level of the salaries paid out to higher-paid employees. An alternative could be the possibility to receive part of the salary in the company’s shares in order to involve an even greater number of the company’s managerial employees in increasing the company’s value in the long term. This way, an employee can legally pay the tax on dividends (if the shares are held) or the tax on capital gains (if the shares are sold) respectively instead of the high labour taxes. If management and advisory services are provided by a non-resident, the Latvian company must withhold a tax of 10\% (Section 3(4)(2) of the Law on Enterprise Income Tax). If this is not done and declared, at the end of the accounting period the company will have to increase the income subject to the enterprise income tax by the remuneration paid, and the tax rate will be 15\%.

**Other Risk Factors Facilitating International Tax Avoidance in Latvia**

**Bank Supervision**

Latvian credit institutions which provide services to non-residents have been involved in several scandals in recent years, where they have been accused of money laundering, while the Latvian State has been accused of the lack of supervision over such institutions. In January 2016, the Baltic Centre for Investigative Journalism Re:Baltica published a study, which summarises the cases of money laundering over the last decade that are connected to non-resident banks and that, despite the existing framework, have not been prevented either by the banks, or their supervisors. At the end of 2015, the US security services raised an alarm about the involvement of Latvian banks in such transactions, and Kristaps Zakulis, head of the Financial and Capital Market Commission Supervisory Board, stepped down as a result of those scandals\textsuperscript{112}. Re:Baltica also points out that the fight of the Latvian authorities against money laundering is inefficient. The number of registered cases of money laundering from 2010 to 2014 is 537, which is 100 to 150 cases per year. By contrast, the number of convictions in those years ranges from 1 to 3. Over those years, the FCMC penalised only 9 banks, reported only 4 potential crimes to law enforcement officers and reported 52 cases to the Financial Intelligence Unit\textsuperscript{113}. Not all of these cases relate to tax evasion, but this aspect cannot be ruled out.

Infographics 6.

**Fight of Latvian Authorities against Money Laundering**

https://infogr.am/ka_lv_iestades_cinas_ar_naudas_atmazgasanu


\textsuperscript{113} Re:Baltica infographics. LV iestāžu “cīna” ar naudas atmazgāšanu [“Fight” of Latvian Authorities against Money Laundering]. Available: [https://infogr.am/ka_lv_iestades_cinas_ar_naudas_atmazgasanu](https://infogr.am/ka_lv_iestades_cinas_ar_naudas_atmazgasanu) (Last accessed on 17.02.2016).
The Latvian Financial Sector Development Plan provides for the development of the Latvian financial sector, without excluding the activities of the credit institutions specialising in the provision of services to non-residents. It also points out that work is being done to minimise the risks – credit risk, liquidity and funding risk, market risk, recapitalisation risk and risk of increase in possible state liabilities posed by the growing deposit base of secured non-residents, as well as money laundering risk and risk of negative influence on the national credit rating in relation to non-residents’ deposits in the Latvian sector of credit institutions. To this end, the credit institutions, whose activities are based on non-resident deposits, are additionally subject to stricter requirements for capital and liquidity, which are regularly reviewed in order to ensure that any increase in the risk is properly reflected in the replenishment of the capital and liquidity. Currently, the framework for inspections – carried out both remotely and on the spot – is being improved. Measures for improving the range of the existing analytical and stress testing tools available to authorities and detecting macro-prudential risks have been implemented.

The FCMC and the Bank of Latvia inform that the risks related to the provision of services to non-residents are being adequately managed and controlled, but it is necessary to continue to work on improving the security, stability and predictability of the segment of non-resident credit institutions. This objective has been taken into account, including for the purposes of designing the preventive measures for the development of the financial sector incorporated in the Plan.\(^{114}\)

It is intended to further strengthen the existing regulatory measures to combat money laundering opportunities through the Latvian financial sector. At the same time, just as much attention should be paid to the practical applicability of the supervisory framework requirements. To achieve this goal, it is necessary to reinforce the capacity of the competent authorities in order to ensure that market participants comply more scrupulously with the applicable regulatory requirements.\(^{115}\)

In February 2016, the Financial and Capital Market Commission adopted Money Laundering and Terrorist Financing Risk Management Regulations, which impose a range of responsibilities on the banks to detect and prevent suspicious transactions.\(^{116}\)

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\(^{115}\) Ibid.

Establishing Bubble Companies

Conducting bogus business activities is a way for unscrupulous entrepreneurs to imitate their activities in some country with the aim of exploiting the relatively favourable taxation rates of that country in order to extend to that country the operating income that was actually received in other countries.

To reduce the possibilities of creating fraudulent schemes in Latvia, a number of legislative amendments against bogus merchants and dishonest business officials have been in effect since 1 January 2014. The State Revenue Service maintains a list of risk persons which is available to the Register of Enterprises. The SRS may decide on winding-up of capital companies and inclusion of individuals into the list of risk persons, while the Register of Enterprises does not allow such persons to register other companies. Previously, the law allowed for suspending the business activity of such enterprises and excluding them from the Register of Value Added Tax (VAT) Payers. (In 2013, the status of a bubble company was given to nearly 8,000 companies. Almost 8,000 companies were excluded from the Register of VAT Payers and more than 5,000 companies had their business activities suspended. The amount of transactions of such commercial companies in the time period from January 2012 to July 2013 was almost 180 million Latvian lats). Persons with tax debts are also included into the list of risk persons.

Latvian legislation obliges credit institutions to check whether their customers are “shell companies”, characterised by one or more of the following features:

- it is impossible to prove that the company is related to actual business activity, and the company’s activity creates little or no economic value, and the credit institution has no documented information proving the contrary;
- the company does not prepare and does not submit annual financial reports on its activities to the competent supervisory authorities;
- the company has no physical place of business, but only a PO Box address or a contact address.

Measures taken in Latvia to detect bubble companies do not yet exclude, for example, a situation when a shop is opened in the “expensive” area of the city and offers for sale a small number of exclusive products at prices which are not commensurate with the

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Determining the Beneficial Owners

In 2011, amendments were made to the Commercial Law, which require the disclosure of the companies’ beneficial owners or offshore owners. The Commercial Law sets forth that a shareholder who holds equity capital shares or stock on his or her behalf, acquiring at least 25% of the capital company shares for another person who is the beneficial owner, has a duty to notify the capital company thereof within 14 days, indicating the person, for whose benefit such shares are held. In turn, the capital company shall, within 14 days from the day of receipt of such notification of the shareholder, submit it to the Commercial Register.

According to the conclusion of the analysis made by journalists in 2013, the data about the beneficial owners of offshore companies may be obtained only by the investigating bodies. Such information is not publicly available. According to the information for 2013 available in the Register of Enterprises, which was instructed by the Saeima (Parliament) to collect the data about the owners of offshore companies: since July 2011, the Register of Enterprises has received submissions regarding beneficial owners from 254 companies, of which at least 25% of the owners are hiding in the offshore areas. There were 157 submissions received in 2011, 82 submissions in 2012 and 15 submissions in 2013. The authority is responsible for collecting and storing the submissions.

This study points out that the estimates made by Lursoft in 2013 show that the Register of Enterprises possesses information only on one third of the companies, of which at least 25% are owned by offshore entities. According to Lursoft estimates, there are at least such 707 companies. It should be noted that the said law applies only to those companies whose owners are in the offshore areas. If the company is registered, for example, in Estonia, its owners are in Germany, while the German company’s owner is in the offshore heaven, the state is not entitled to know who the beneficial owners are. The most common countries where the companies linked to transactions in Latvia have been established are the British Virgin Islands (150 offshore companies), Belize (103 offshore companies) and the Republic of Panama (89 offshore companies).

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123 Ibid.
As acknowledged by the authors of both TJN and EU studies, the framework for determining beneficial owners in Latvia is partial and declarative, and the data provided by the companies are not checked.

**Tax Treaties Signed by Latvia**

Latvia has entered into tax treaties with 58 countries, including almost all the European Union countries, the US, Canada, China, Belarus, Ukraine, Kazakhstan, Uzbekistan, Azerbaijan, and Russia. They are available on the website of the State Revenue Service. These treaties are based on the OECD model. The treaties are symmetrical, that is, both parties have the right to impose taxes on the taxpayers of the other party in accordance with the rates agreed upon between the parties. If such a treaty has been concluded between economically similarly developed countries and an equally high volume of investment in both directions is expected, this does not cause any damage to any of the parties.

There is a clause in the treaties concluded by Latvia which states that the treaty may not be used to evade taxes. For example, the protocol on the avoidance of double taxation with Russia sets forth: “It is understood that a resident of a Contracting State shall not be entitled to any reduction in or exemption from taxes as provided for in this Agreement on income derived from the other Contracting State if as a result of consultations between the competent authorities of both Contracting States it is established that the main purpose or one of the main purposes of the creation or existence of such resident was to obtain the benefits under this Agreement that would not otherwise be available.”

No treaties have been concluded with developing countries, so it is unlikely that Latvian entrepreneurs may use them directly, reducing the tax revenues of developing countries. However, since Latvia is a country which may be beneficial to involve in a variety of major tax reduction schemes, it is not excluded that some of the international companies have established related companies in Latvia and are gaining profits through them, while paying minimal taxes in Latvia and not paying due share of taxes also in one of the developing countries. Given that a number of treaties have been concluded with the more prosperous countries, it would be appropriate to carry out an analysis of whether those treaties are not adverse to Latvia. In cases where the treaties do not provide Latvia with the right to charge tax when the business activity is carried out in Latvia, such treaties should be revised. A closer analysis of the tax treaties has not been conducted within this research.

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124 State Revenue Service website. Tax conventions.
Conclusions

- The currently existing national tax policy in a number of countries, and international agreements fail to prevent international tax avoidance, and in many cases they contribute to tax dodging.
- If companies evade taxes on the international scale, the losers mostly are the poor and developing countries, as well the poorest people in the wealthier countries.
- Interrelated factors that contribute to the tax evasion on the international scale:
  - national competition for investment resulting in low taxes for certain types of income;
  - unfair tax treaties between countries;
  - secrecy in the financial and banking sector;
  - insufficient control over the internationally structured businesses.
- Some of the conditions can be prevented within countries, while others can be eliminated only at the international level, when countries agree on common policies and actions.
- Internationally, combating tax evasion is advocated by intergovernmental organisations: the Organisation for Economic Cooperation and Development, the European Union, international non-governmental organisations (such as the Tax Justice Network), as well as the United Nations’ multilateral initiative Open Government Partnership.
- Several risk factors are present in Latvia, and when these factors interact, a contribution to international tax evasion is promoted. The risks include:
  - low taxes for certain types of legal entities’ income from cross-border sources (dividends, interest payments and intellectual property payments), which are not related to cooperation agreements between the countries regarding the tax information exchange;
  - weak control over the bank sector;
  - ineffective policy in determining the actual beneficiaries;
  - weak capacity in exposing fictitious enterprises.
- Latvia does not have an extensive economic cooperation with poorest countries, and no bilateral tax treaties so far have been concluded with these countries. It suggests that Latvia does not directly encourage the reduction of developing countries’ tax revenue. However, it may be indirectly involved in schemes, whereby companies strive to reduce the taxes paid in these countries.
Recommendations

Since the problems have been arisen historically by states competing in a more or less liberal international market, the solutions should be searched for on an international level as well by agreeing on a policy which would eliminate the existing injustice.

The following courses of action are recommended for Latvia:

- To explain and implement the policy directions recommended by the Organisation for Economic Cooperation and Development to prevent international tax evasion.
- To support the Action Plan, which has been recommended by the European Commission, in the debates at the European Parliament and to promote its implementation in Latvia.
- To decline further possible tax reduction on cross-border transactions.
- To assess the prospects to discontinue the low cross-border tax regime attribution to the countries with which Latvia has no bilateral agreements on exchange of information regarding taxes until the bilateral agreements are concluded.
- Given that a number of treaties have been concluded with the more prosperous countries, it would be appropriate to carry out an analysis of whether those treaties are not adverse to Latvia. In cases where the treaties do not provide Latvia with the right to charge tax when the business activity is carried out in Latvia, such treaties should be revised.
- To strengthen the capacity of the State Revenue Service, the Financial and Capital Market Commission and other law enforcement institutions to expose and prevent tax evasion cases at the international level.
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