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Avoidance of Double Taxation in the Area of Income Tax in Latvia

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The article is dedicated to the experience of preventing double taxation in the Republic of Latvia, the area of income tax. This topic is made relevant by the tax reform implemented in 2018. Although the payment of income tax has been conceptually changed, the authors propose the thesis regarding a constant approach to prevention of double taxation, based on recommendations by the Organisation for Economic Co-operation and Development (hereinafter – OECD). In the framework of income tax reform, additional requirements have been integrated into regulatory enactments to eliminate the possibility of tax evasion.

Keywords: tax law, direct tax, indirect tax, double taxation, avoidance of double taxation, resident for taxation purposes.

Contents

<i>Introduction</i>	69
1. <i>Legitimacy of Taxes</i>	70
2. <i>Avoidance of Double Taxation by Residency Tiebreaker Method</i>	73
3. <i>Avoidance of Double Taxation by Using Relief and Credit Methods</i>	76
3.1. <i>Avoidance of Double Taxation in Case of Applying PIT</i>	76
3.1.1. <i>Avoidance of Double Taxation with Relief Method</i>	76
3.1.2. <i>Avoidance of Double Taxation by Credit Method</i>	77
3.2. <i>Avoidance of Double Taxation in Case of Applying Enterprise Income Tax</i>	78
3.2.1. <i>Avoidance of Double Taxation by Relief and Credit Method</i>	78
3.2.2. <i>The Case of Transfer Pricing</i>	80
<i>Summary</i>	82
<i>Sources</i>	82
<i>Bibliography</i>	82
<i>Case Law</i>	84

Introduction

The state is sovereign in its right to legislate, which includes the right to levy and collect taxes within its jurisdiction. Double taxation occurs if more than one state claims the income of the same person within the same taxation period.¹ To put it differently: international double taxation is linked to the identity of the subject of taxes (payer), the object of taxes (source of income and income), subjects being within various tax jurisdictions (different definitions for determining the status of a resident for taxation purposes), simultaneous levying of taxes (various rules on applying the source or the income of the country of residence), different methods and rules on determining the taxable object.²

Apart from levying taxes on residents, states usually apply taxes also to transactions, which have been conducted in the respective jurisdiction or income, the origins (source) of which are in the respective jurisdiction. Thus, although the state of income origin may not be the country of residence of the resident for taxation purposes, the tax commitments remain also in the state of income origin / source.³

If the tax burden is disproportionately high, double taxation becomes a problem for the taxpayer and also for the state's competitiveness. Of course, a rhetorical question may be apposite – what kind of tax burden should be deemed to be disproportionately high? One can assume that demanding to pay more than 50% of a person's total income in taxes is disproportional.⁴ For instance, if, in the Republic of Latvia, the rate 20, 23 and 31.40%⁵ is applied to a natural person's income of the taxation year and in the Republic of Austria the same income was applied 25–50, 55% rate⁶ then, obviously, demanding the taxpayer to meet the tax commitments simultaneously in both countries in accordance with the principle of taxing worldwide income would be disproportional.

To avoid double consumption (indirect) taxation in cross-border transactions, the indirect taxes are aligned (harmonised) in the Member States of the European Union (hereinafter – the EU).⁷ The EU Member States have been granted

¹ *Frotscher, G. Internationales Steuerrecht. 4, völlig überarbeitete Auflage. München: Verlag C. H. Beck, 2015, S. 3.*

² *Ketners, K. Nodokļi un nodokļu plānošanas principi [Tax and principles of tax planning]. Rīga: SIA "Tehnoinform Latvia", 2018, pp. 154–156.*

³ *Ketners, K., Pētersone, M. Eiropas Savienības nodokļu politika [European Union tax policy]. Rīga: RTU Press, 2014, pp. 47–50; Vogel, K. et al. Klaus Vogel on Double Taxation Conventions. A Commentary to the OECD-, UN- and US Model Conventions for the Avoidance of Double Taxation on Income and Capital. With Particular Reference to German Treaty Practice. 3rd edition. London: Kluwer Law International Ltd., 1995, p. 9.*

⁴ *Frotscher, G. Internationales Steuerrecht. 4., völlig überarbeitete Auflage. München: Verlag C. H. Beck, 2015, S. 3.*

⁵ Par iedzīvotāju ienākuma nodokli [On Personal Income Tax] (11.05.1993), art. 15.2. Available: <https://likumi.lv/doc.php?id=56880> [last viewed 20.04.2019].

⁶ Für Einkommensteile über eine Million Euro beträgt der Steuersatz in den Kalenderjahren 2016 bis 2020 55% [In Austria, in 2016–2020 55% tax rate is applied to income exceeding 1 million euros]. Über die Besteuerung des Einkommens natürlicher Personen (07.07.1988), art. 33. Available: <https://www.ris.bka.gv.at/GeltendeFassung.wxe?Abfrage=Bundesnormen&Gesetzesnummer=10004570> [last viewed 20.04.2019].

⁷ *Līgums par Eiropas Savienības darbību [The Treaty on the Functioning of the European Union], art. 113. Available: <https://eur-lex.europa.eu/legal-content/LV/TXT/?uri=CELEX%3A12012E%2FTXT> [last viewed 20.04.2019].*

considerable discretion in the field of direct taxes.⁸ Harmonisation of direct taxes in the EU can be discussed only conditionally, and, thus, the EU Member States in many ways shoulder the avoidance of double taxation.⁹

On 1 July 2016, Latvia officially became the 35th Member State of OECD.¹⁰ Although even prior to this Latvia, as regards avoidance of double taxation, followed the OECD recommendations, the accession to this organisation increases Latvia's responsibility in this respect.

The aim of the article is to examine the experience in the avoidance of double taxation in the area of income taxes in the Republic of Latvia, *inter alia*, the established legitimacy of taxes in the judicature of the Constitutional Court of the Republic of Latvia (hereinafter – the Constitutional Court) and in the case law of the Latvian courts.

1. Legitimacy of Taxes

The *Satversme* [Constitution] of the Republic of Latvia (hereinafter – the *Satversme*) provides that the property right may be restricted only on the basis of law.¹¹ In Latvia, all taxation laws have been established on the basis of law.¹² Thus, formally, the requirements of the *Satversme* have been met. However, the *Satversme* does not provide an answer to the question, whether the restriction on fundamental rights, imposed by particular taxation laws, is proportionate and reaches the legitimate aim in a democratic society. The Constitutional Court has analysed the compliance of tax law with the *Satversme* in a number of judgements.

The Constitutional Court notes that “[t]he state, in determining and implementing its taxation policy, enjoys broad discretion.”¹³ “It comprises the right to choose the tax rates and categories of persons for whom these are envisaged, as well as the right to define the details of the respective regulation.”¹⁴ “The

⁸ See for instance, *Margaret Block vs. Finanzamt Kaufbeuren*, No. C-67/08, para. 31. Available: <http://curia.europa.eu/juris/document/document.jsf?jsessionid=631055E95D4364261C819C062E8BCF81?text=&docid=76237&pageIndex=0&doclang=LV&mode=lst&dir=&occ=first&part=1&cid=12000413> [last viewed 20.04.2019]; *Marks & Spencer plc. vs. David Halsey* (Her Majesty's Inspector of Taxes), No. C-446/03, para. 29. Available: <http://curia.europa.eu/juris/document/document.jsf?text=&docid=57067&pageIndex=0&doclang=LV&mode=lst&dir=&occ=first&part=1&cid=12001880> [last viewed 20.04.2019] or *Frotscher, G. Internationales Steuerrecht*. 4., völlig überarbeitete Auflage. München: Verlag C. H. Beck, 2015, S. 102; *Lazdiņš, J., Ketners, K. The Effect of Court Rulings on the Dynamics of the Latvian Tax Law. Journal of the University of Latvia. Law*, No. 5, 2013, p. 31.

⁹ *Haase, F. Internationales und Europisches Steuerrecht*. 4., neu bearbeitete Auflage. Heidelberg, München, Landsberg, Frechen, Hamburg: C. F. Müller, 2014, S. 17–18.

¹⁰ Līgums par Latvijas Republikas pievienošanās konvencijai par Ekonomiskās sadarbības un attīstības organizāciju nosacījumiem [Agreement on the terms of accession of the Republic of Latvia to the convention on the Organisation for Economic Co-operation and Development] (29.04.2016). Available: <https://likumi.lv/ta/lv/starptautiskie-ligumi/id/1249> [last viewed 20.04.2019].

¹¹ Latvijas Republikas Satversme [The Constitution of the Republic of Latvia], art. 105 (15.02.1922). Available: <https://likumi.lv/doc.php?mode=DOC&id=57980> [last viewed 20.04.2019].

¹² Par nodokļiem un nodevām [On Taxes and Duties], art. 8 (02.02.1995). Available: <https://likumi.lv/doc.php?id=33946> [last viewed 20.04.2019].

¹³ Latvijas Republikas Satversmes tiesas 2011. gada 20. maija spriedums lietā Nr. 2010-70-01 [Judgement of 20 May 2011 by the Constitutional Court of the Republic of Latvia in case No. 2010-70-01], para. 9. Available: http://www.satv.tiesa.gov.lv/wp-content/uploads/2016/02/2010-70-01_Spriedums.pdf [last viewed 20.04.2019].

¹⁴ Latvijas Republikas Satversmes tiesas 2015. gada 25. marta spriedums lietā Nr. 2014-11-0103 [Judgement of 25 March 2015 by the Constitutional Court of the Republic of Latvia in case No. 2014-

legislator's choice, which tax would be necessary, is a matter of expedience".¹⁵ "In examining the limits of the legislator's discretion with respect to determining a tax for a particular object, it should be taken into account that the *Satversme expressis verbis* authorises the legislator to adopt the state budget, thus, to determine the revenue and the expenditure of the state. The *Satversme* authorises the legislator to implement such fiscal policy that ensures the necessary income for the state."¹⁶

In specifying the legitimacy of restricting the property right, the Constitutional Court, referring to the established judicature of the Federal Constitutional Court of Germany, notes that "a person's fundamental right to property is not violated if the State imposes upon a person public law obligations to make monetary payments, which are not an excessive burden for this person and do not significantly influence his financial situation."¹⁷ The Constitutional Court has "borrowed" findings of similar content also from the Constitutional Court of the Republic of Lithuania and the Constitutional Court of the Kingdom of Belgium.¹⁸ The final conclusion derived from this is that "in a democratic state governed by the rule of law, the right to property is not absolute"¹⁹. Thus, the Constitutional Court has not identified a contradiction with the *Satversme* in the obligation to pay taxes.

Solidarity Tax Law²⁰, adopted on 11 November 2015, which was perceived controversially by the society, and the double constitutional review of some norms of the law turned into a certain exception.²¹

The solidarity tax was introduced at the moment when a natural person's income was levied the personal income tax in accordance with a proportional rate (23%).²² In Latvia, salaried employees and performers of economic activities as self-employed persons are subject to state mandatory social insurance contributions (hereinafter – SMSIC). The so-called contribution 'ceiling' has been set for SMSIC, i.e., contributions are discontinued upon reaching the maximum,

11-0103], para. 20. Available: http://www.satv.tiesa.gov.lv/wp-content/uploads/2016/02/2014-11-0103_Spriedums.pdf [last viewed 20.04.2019].

¹⁵ Latvijas Republikas Satversmes tiesas 2017. gada 19. oktobra spriedums lietā Nr. 2016-14-01 [Judgement of 19 October 2017 by the Constitutional Court of the Republic of Latvia in case No. 2016-14-01], para. 23. Available: <http://www.satv.tiesa.gov.lv/web/viewer.html?file=http://www.satv.tiesa.gov.lv/wp-> [last viewed 20.04.2019].

¹⁶ Constitutional Court of the Republic of Latvia, Judgment on case No. 2014-11-0103, para. 20.

¹⁷ Latvijas Republikas Satversmes tiesas 2010. gada 6. decembra spriedums lietā Nr. 2010-25-01 [Judgement of 6 December 2010 by the Constitutional Court of the Republic of Latvia in case No. 2010-25-01], para. 10. Available: http://www.satv.tiesa.gov.lv/web/viewer.html?file=http://www.satv.tiesa.gov.lv/wp-content/uploads/2016/02/2010-25-01_Spriedums.pdf#search= [last viewed 20.04.2019].

¹⁸ Ibid.

¹⁹ Latvijas Republikas Satversmes tiesas 2010. gada 19. jūnija spriedums lietā Nr. 2010-02-01 [Judgement of 9 June 2010 by the Constitutional Court of the Republic of Latvia in case No. 2010-02-01], para. 6. Available: http://www.satv.tiesa.gov.lv/wp-content/uploads/2016/02/2010-02-01_Spriedums.pdf [last viewed 20.04.2019].

²⁰ Solidaritātes nodokļa likums [Solidarity Tax Law] (30.11.2015). Available: <https://likumi.lv/ta/id/278636-solidaritates-nodokla-likums> [last viewed 20.04.2019].

²¹ Constitutional Court of the Republic of Latvia, Judgment on case No. 2016-14-01, para. 2; Latvijas Republikas Satversmes tiesas 2017. gada 16. novembra spriedums lietā Nr. 2016-16-01 [Judgement of 16 November 2017 by the Constitutional Court of the Republic of Latvia in case No. 2016-16-01], para. 3. Available: http://www.satv.tiesa.gov.lv/web/viewer.html?file=http://www.satv.tiesa.gov.lv/wp-content/uploads/2017/11/2016-16-01_Spriedums.pdf#search= [last viewed 20.04.2019].

²² See On Personal Income Tax, historical consolidated version of the law 01.07.–02.12.2015, art. 15. Available: <https://likumi.lv/doc.php?id=56880> [last viewed 20.04.2019].

to which SMSIC is applied, which is determined by the state.²³ Hence, persons with high income participated in social solidarity, proportionally to their income, disproportionately less than other salaried employees or self-employed performers of economic activities.

SMSIC, which exceeded the SMSIC 'ceiling'²⁴ were defined as the object of solidarity tax. The tax payment was transferred into the basic state budget. At the moment of its adoption, the solidarity tax could be treated as a specific income tax²⁵ with the aim of decreasing the regression of taxes.²⁶ Levelling of the tax burden between the various groups of taxpayers was also compatible with the principle of a socially responsible state defined in the *Satversme*.²⁷

SMSIC rate is not the same for all those, who make social contributions. It depends on the person's employment, age and other circumstances or the social risks that the payer could be subject to. For example, a person, who has reached the retirement age, is not insured against unemployment since he cannot lose the source of income – pension.²⁸ If differentiation in the case of SMSIC can be legitimately justified the same could not apply to the solidarity tax as an income tax. Therefore, the Constitutional Court, validly, recognised as being incompatible with the principle of equality enshrined in the *Satversme* not the solidarity tax as such but only the different tax rates for groups of solidarity tax payers.²⁹

After the constitutional complaints were submitted but before the judgements of the Constitutional Court in the solidarity tax cases were pronounced, significant amendments were introduced to Solidarity Tax Law, transforming the solidarity tax into a hybrid tax; i.e., the solidarity tax is simultaneously a payment of income tax and social insurance contribution.³⁰

On 1 January 2018, significant amendments to the law "On Personal Income Tax" (hereinafter – PIT) entered into force. Personal income is no longer subject to the proportional tax rate (23%); instead, a progressive tax rate is introduced (20, 23 and 31.4%). At present, regression in paying taxes can be discussed only up to a point, and paying of the solidarity tax probably does not meet the initial aim of decreasing regression in paying taxes.

The Constitutional Court's findings in the tax cases probably should not be viewed as an innovation. Regretfully, the Constitutional Court, just like the Latvian legal science, is silent about the inadmissibility of double taxation or the possible solutions to it. However, the Constitutional Court has recognised the

²³ At the moment of introducing Solidarity Tax Law, the 'ceiling' of SMSIC contributions in the taxation year was 48 600 euro (in 2018, the maximum amount of SNSIC has reached 55 000 euro). See Par valsts sociālās apdrošināšanas obligāto un brīvprātīgo iemaksu objekta minimālo un maksimālo apmēru [Regulations Regarding the Minimum and Maximum Amount of the Object of Mandatory and Voluntary Contributions of State Social Insurance], art. 5 (17.12.2013). Available: <https://likumi.lv/doc.php?id=263238> [last viewed 20.04.2019].

²⁴ SMSIC are paid both by the employer and the employee. Thus, the payers of solidarity tax also are employers and employees.

²⁵ Constitutional Court of the Republic of Latvia, Judgment in case No. 2016-14-01, para. 19.3.

²⁶ Solidarity Tax Law, art. 2.1.

²⁷ See The Constitution of the Republic of Latvia, Preamble.

²⁸ Par valsts sociālo apdrošināšanu [On State Social Insurance], art. 6.2 (01.10.1997). Available: <https://likumi.lv/doc.php?id=45466> [last viewed 20.04.2019].

²⁹ Constitutional Court of the Republic of Latvia, Judgment in case No. 2016-14-01, para. 27.3.

³⁰ Solidarity Tax Law, qrt. 9.

legitimacy of Latvian taxes (except the different tax rates of Solidarity Tax Law³¹) and, consequently, also the compliance of the tax conventions that have entered into force and the methods for avoiding double taxation established in the national regulatory enactments with the *Satversme*.

2. Avoidance of Double Taxation by Residency Tiebreaker Method

The residency tiebreaker method is an internationally recognised method for avoiding double taxation. The residency tiebreaker is regulated by the national legislation and the tax conventions on the international level. In this respect, Latvia is not an exception.³² Hence, the national criteria for determining residency for taxation purposes are supplemented by the concluded tax conventions. The priority of international treaties has been established in Latvia. If the norms of international treaties ratified by the *Saeima* (the Parliament) collide with the national legislation then the rules of the international treaty are applied.³³

Pursuant to the law “On Taxes and Duties” (hereinafter – TaD), taxes and duties (hereinafter – the tax) are paid by the domestic taxpayers (residents) and foreign taxpayers (non-residents).³⁴ The law recognises as taxpayers natural persons, legal persons and associations (groups) of these persons. Residents pay taxes from worldwide income, whereas non-residents – from the income gained in Latvia. The circle of payers of a particular tax is defined in each particular tax law.

In accordance with TaD article 14, a natural person is considered to be a resident of Latvia if:

- 1) his declared place of residence is in the Republic of Latvia; or
- 2) he stays in the Republic of Latvia for 183 days or longer during any 12-month period beginning or ending in a taxation year; or
- 3) he is a Latvian citizen, who is employed in a foreign country by the government of the Republic of Latvia.³⁵

Instead of the term ‘declared place of residence’ used in the national legislation, the term ‘permanent place of residence’ is used in tax conventions. In Latvia, the personal income tax is split between the state budget and the local governments’ budgets. In accordance with the declared place of residence, the largest part of PIT is transferred into the budget of the local government, where the place of residence is declared.³⁶ Of course, from the perspective of international tax law, it matters only whether Latvia is or is not a natural person’s permanent place of residence.

The criterion of 183 days does not apply to the particular taxation year. A person’s physical staying for 183 days or longer within the period of 12 months, which begins or ends in a taxation year, is essential. The date of reference for

³¹ Enforcing the Constitutional Court’s judgement, since 1 January 2019 the solidarity tax rate for all taxpayers is 25.50 per cent. See Grozījumi Solidaritātes nodokļa likumā [Amendments to Solidarity Tax Law] (20.12.2018). Available: <https://likumi.lv/ta/id/304032-grozijumi-solidaritates-nodokla-likuma> [last viewed 20.04.2019].

³² Augstākās tiesas 2016. gada 12. decembra spriedums lietā Nr. SKA-739/2016 (A420479613) [Judgement of 12 December 2016 by the Supreme Court in case No. SKA-739/2016 (A420479613)], para. 8. Available: https://manas.tiesas.lv/eTiesasMvc/lv/nolemumi; file:///C:/Users/LU%20JF/Downloads/Anonimizets_nolemums_291360.pdf [last viewed 20.04.2019].

³³ On Taxes and Duties, art. 7.1; On Personal Income Tax, art. 24.

³⁴ On Personal Income Tax, art. 14.1.

³⁵ On Taxes and Duties, art. 14.2–3.

³⁶ In recent years, this proportion has been set as 80% against 20%, in favour of the local governments’ budgets.

acquiring the resident's status is the first arrival of a natural person to Latvia in the respective period. After leaving Latvia, in the presence of closer ties with the foreign country, the natural person is no longer considered as being a resident of Latvia. TaD recognises only three criteria as closer ties or a foreign centre of vital interests:

- 1) a natural person owns property in the foreign country;
- 2) the family is residing in the foreign country;
- 3) the person makes social insurance contributions in the foreign country.³⁷

In view of the legal construction of TaD article 14, it can be concluded that the determination of the residency of a natural person cannot be based solely on the territorial principle. Property, family or social insurance contributions made abroad are recognised as essential criteria. The criteria for residence tiebreaker are supplemented by the tax conventions that Latvia has entered into.³⁸

Tax conventions single out five criteria for determining the residence status of a natural person.³⁹ For example, from the Convention between the government of the Republic of Latvia and the government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains⁴⁰, apart from the criterion of permanent life, described above [1]) four other criteria are singled out:

- 2) with a permanent place of residence in both states – parties to the contract, a natural person is considered to be resident of that country, with which it is connected with the so-called 'centre of vital interests' or closer personal or economic ties.

In the tax theory, closer personal and economic ties are understood as a person's intention to settle for living in the respective state for a prolonged period rather than for a relatively short period of time (for example, while travelling or studying).

³⁷ On Taxes and Duties, art. 14.3.

³⁸ Eiropas nodokļi Latvijā [European Taxes in Latvia]. Rīga: Latvijas Ekonomists, Ernst & Young, 2004, pp. 133–135.

³⁹ See for instance Par Latvijas Republikas un Amerikas Savienoto Valstu konvenciju par nodokļu dubultās uzlikšanas un nodokļu nemaksāšanas novēršanu attiecībā uz ienākuma nodokļiem [Convention between the Republic of Latvia and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income], art. 4.4 (14.05.1998). Available: <https://likumi.lv/doc.php?id=48313> [last viewed 20.04.2019]; Par Latvijas Republikas un Austrijas Republikas konvenciju par nodokļu dubultās uzlikšanas novēršanu attiecībā uz ienākuma un kapitāla nodokļiem [Convention between the government of the Republic of Latvia and the Republic of Austria for the avoidance of double taxation with respect to taxes on income and capital], art. 4.2 (25.05.2006). Available: <https://likumi.lv/doc.php?id=137397> [last viewed 20.04.2019]; Latvijas Republikas valdības un Krievijas Federācijas valdības līgums par nodokļu dubultās uzlikšanas un nodokļu nemaksāšanas novēršanu attiecībā uz ienākuma un kapitāla nodokļiem [Agreement between the Government of the Russian Federation for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital], art. 4.2 (09.06.2011). Available: <https://likumi.lv/doc.php?id=232250> [last viewed 20.04.2019]; Par Latvijas Republikas un Vācijas Federatīvās Republikas līgumu par nodokļu dubultās uzlikšanas novēršanu attiecībā uz ienākuma un kapitāla nodokļiem [Agreement between the Republic of Latvia and the Federal Republic of Germany for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital], art. 4.2 (15.05.1997). Available: <https://likumi.lv/doc.php?id=43580> [last viewed 20.04.2019], etc.

⁴⁰ Par Latvijas Republikas valdības un Lielbritānijas un Ziemeļīrijas Apvienotās Karalistes valdības konvenciju par nodokļu dubultās uzlikšanas un nodokļu nemaksāšanas novēršanu attiecībā uz ienākuma un kapitāla pieauguma nodokļiem [Convention between the government of the Republic of Latvia and the government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains] (06.11.1996). Available: <https://likumi.lv/doc.php?id=41331> [last viewed 20.04.2019].

In determining a natural person's 'centre of vital interests', also the place where the family resides, social, political and cultural activities, the possible location of property owned by the person, the place where professional activities are conducted, etc. are used as criteria. A person should not be recognised as a resident for taxation purposes only because a duty to pay taxes arises in a country due to income or capital.⁴¹

In the Latvian case law, the concept of 'the centre of vital interests' has not been extensively analysed with the purpose of breaking residence ties. Stable judicature has not evolved. Only some court rulings are available. Thus, for example, on the basis of a judgement by the Court of Justice of the European Communities⁴², the Administrative Regional Court (appellate instance court) recognised as the resident of the Kingdom of Denmark a Latvian national, 25 years old, single, who had lived and worked in Denmark for almost eighteen months. Although the natural person had declared his place of residence in Latvia, the Administrative Regional Court recognised the place of employment and permanent residence in the Kingdom of Denmark as 'the centre of interests' and, hence, as the decisive criterion in determining residency, because during this period this person had had neither family nor any other enduring personal or economic interests in Latvia⁴³. In improving the case law in determining the residence for taxation purposes, the Supreme Court has recognised that returning to a country for permanent life *per se* does not change the residency for taxation purposes with respect to the previous years. In the context of the free movement of persons, it is clear that a person may change and often changes his place of sojourn.⁴⁴

- 3) if the country of residence cannot be determined in accordance with the first two criteria then a natural person is considered as being the resident of that country, which is his habitual place of residence;
- 4) if the previous criteria do not allow determining a natural person's country of residence then the nationality (citizenship) becomes the decisive criterion; but
- 5) if a natural person is the citizen of both these states or is not the citizen of any of them then the authorities of the countries party to the convention decide this matter through mutual agreement.

A taxpayer, which is not a natural person, is considered as the resident of Latvia for taxation purposes if it has been established and registered or should have been established and registered in accordance with the laws of the Republic of Latvia.

The place of a taxpayer's registration (incorporation) is not recognised as the decisive criterion in determining the country of residence everywhere. Thus, the criterion of internationally effective place of management (the place where

⁴¹ Ketners, K., Pētersone, M. Eiropas Savienības nodokļu politika [European Union tax policy]. Rīga: RTU Press, 2014, pp. 47–49; Ketners, K. Nodokļi un nodokļu plānošanas principi [Tax and principles of tax planning]. Rīga: SIA "Tehnoinform Latvia", 2018, pp. 148–156.

⁴² The European Court of Justice, *Robin Swaddling and Adjudication Officer*, C-90/97, 25 February 1999. Available: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:61997CJ0090&from=EN> [last viewed 20.04.2019].

⁴³ Administratīvās apgabaltiesas 2014. gada 22. decembra spriedums lietā Nr. A4206664311 [Judgement of 22 December 2014 by the Administrative Regional Court in case No. A4206664311], archive number of the case No. AA43-1524-14/13, para. 13. Available: <https://manas.tiesas.lv/eTiesasMvc/lv/nolemumi> [last viewed 20.04.2019].

⁴⁴ Augstākās tiesas 2012. gada 12. decembra spriedums lietā Nr. SKA-538/2012 (A42954809) [Judgement of 12 December 2012 by the Supreme Court in case No. SKA-538/2012 (A42954809)], Paras. 9, 11–12. Available: <http://www.at.gov.lv/lv/judikatura/judikaturas-nolemumu-arhivs/administrativo-lietu-departaments/hronologiska-seciba?year=2012> [last viewed 20.04.2019].

management is located) is used, for example, in Switzerland, Germany, Italy and Russia.⁴⁵ A company's place of effective management can be determined on the basis of the location of the board ('day-to-day management test') or the place where strategic decisions are adopted ('place of strategic management').

Pursuant to different criteria for determining residency in different states, a taxpayer may simultaneously be the resident of not only Latvia. In a case like this, the tax conventions that are in force in Latvia establish the obligation of authorities⁴⁶ to attempt to resolve this matter through mutual agreement. In the absence of such an agreement, the person is not recognised as a resident in any of the states party to the convention for receiving the reliefs envisaged in the convention.⁴⁷

3. Avoidance of Double Taxation by Using Relief and Credit Methods

To avoid double taxation, the tax conventions of the EU Member States and the national legislation in many ways are drafted, using the OECD Model Tax Convention⁴⁸ (Model Tax Convention on Income and on Capital).⁴⁹ Also in Latvia, in accordance with OECD model, the relief and credit method can be discussed in connection with avoidance of double taxation with respect to income taxes. As regards the role of the EU law in avoidance of double taxation, the ECJ case C-128/08 (*Jacques Damseaux v. État belge*) must be taken into account, in the case, a limited EU competence to demand from the Member States avoidance of double taxation is recognised⁵⁰, i.e., the EU law, in its current status, does not define general criteria for allocation of competence among the Member States with respect to avoidance of double taxation. Adverse consequences that follow from the parallel exercise of Member States' tax competence, unless such exercise is discriminatory, are not a prohibited restriction.

3.1. Avoidance of Double Taxation in Case of Applying PIT

3.1.1. Avoidance of Double Taxation with Relief Method

In Latvia, courts view the relief from application of the income tax as an exception to the general obligation to pay taxes. Therefore, the relief method is

⁴⁵ See *Maisto, G.* (ed.). *Residence of Companies under Tax treaties and EC Law* (Vol. 5). IBFD, 2009; *De Broe, L.* *International tax planning and prevention of abuse: A study under domestic tax law, tax treaties, and EC law in relation to conduit and base companies* (Vol. 13). IBFD, 2008.

⁴⁶ In Latvia – the State Revenue Service.

⁴⁷ See for instance Convention between the Republic of Latvia and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 4.5–6; Convention between the government of the Republic of Latvia and the Republic of Austria for the avoidance of double taxation with respect to taxes on income and capital, art. 4.3; Agreement between the Government of the Russian Federation for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, art. 4.3; Agreement between the Republic of Latvia and the Federal Republic of Germany for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital, art. 4.3.

⁴⁸ *Terra, B. J. M., Wattel, P. J.* *European tax law*. 4th edition. The Hague: Kluwer Law International, 2005, pp. 100–105.

⁴⁹ Model Tax Convention on Income and on Capital. Condensed version (as it read on 21 November 2017). OECD. Available: https://www.oecd-ilibrary.org/docserver/mtc_cond-2017-en.pdf?expire_s=1550576533&tid=id&accname=oid019822&checksum=44D7021F19867B274B1658A4964861EB [last viewed 20.04.2019], pp. 376–406.

⁵⁰ *Jacques Damseaux vs. État belge*, No. C-128/08, 16 July 2009. Available: <https://eur-lex.europa.eu/legal-content/LV/TXT/HTML/?uri=CELEX:62008CJ0128&from=LV> [last viewed 20.04.2019].

applicable only with respect to certain types of income concretely defined in the law and it cannot be applied by analogy. The relief method is interpreted as a special method (special norm) with respect to the credit method in the avoidance of double taxation.⁵¹

Article 24(7) of PIT provides that paid work income of the resident of Latvia is not subject to the personal income tax if three conditions are complied with concurrently:⁵²

- 1) paid work income obtained for the performance of work duties in another Member State of the European Union or European Economic Area State, or in a state with which Latvia has entered into a convention for the avoidance of double taxation and the prevention of fiscal evasion and it has come into force;
- 2) paid work income obtained in the relevant foreign state is subject to personal income tax or similar tax thereto;
- 3) the payer is not personnel, which is hired by a lessor of personnel to a lessee of personnel (resident of Latvia or permanent representation of the non-resident in Latvia). The lessor of the personnel is not a resident of Latvia or permanent representation.⁵³

With the employer and the employee being resident of Latvia, the exemption from PIT for the income abroad will be applicable only in the case if the employer has submitted to the Latvian tax administration⁵⁴ confirmation that an income tax is applied to the income from the salary abroad. In addition to that, in the notification to the Latvian tax administration, the employed employee and the periods of his employment must be identified.⁵⁵

Hence, the relief from the obligation to pay the tax in Latvia applies only to the resident's for taxation purposes income from salary abroad, not permitting a situation where the income tax is not paid altogether.

3.1.2. Avoidance of Double Taxation by Credit Method

Thus, avoidance of double taxation by the credit method should be examined as the general method for avoiding double taxation. In applying the credit method, the calculated tax is decreased by the amount, which is equal to the tax that has been paid abroad. The decrease may not exceed the sum that would be equal to the tax for income abroad calculated in Latvia. For the right to the tax credit to be recognised, the taxpayer must submit a certified document of the foreign tax administration on the income that has been taxed and the paid amount of tax. The right to decrease the tax calculated in Latvia by the income tax paid abroad is examined individually with respect to each foreign state.⁵⁶

⁵¹ Administratīvās apgabaltiesas 2017. gada 30. novembra spriedums lietā Nr. A420282416 [Judgement of 30 November 2017 by the Administrative Regional Court in case No. A420282416], archive number of the case No. AA43-1321-17/14, ECLI:LV:ADAT:2017:1130.A420282416.2.S, para. 5.2. Available: <https://manas.tiesas.lv/eTiesasMvc/lv/nolemumi> [last viewed 20.04.2019].

⁵² The personal income tax relief does not apply to a natural person's income from work if a person is employed on a ship used in international transportation. See On Personal Income Tax, art. 8.4, 24.8.

⁵³ On Personal Income Tax, art. 17¹, 24.2,7.

⁵⁴ To the State Revenue Service.

⁵⁵ On Personal Income Tax, art. 27.7¹.

⁵⁶ See On Personal Income Tax, art. 24.3–4; Uzņēmumu ienākuma nodokļa likums [Enterprise Income Tax Law], art. 15.1–3 (28.07.2017). Available: <https://likumi.lv/ta/id/292700-uznemumu-ienakuma-nodokla-likums> [last viewed 20.04.2019].

Latvia's case law regarding the interpretation of the application of the credit method is not extensive. However, some findings are noteworthy for the application of tax law. Thus, for example, it has been noted in the courts' judicature that if the income tax paid abroad exceeds the personal income tax to be calculated in Latvia, then, for the taxpayer, the income tax paid abroad is the final tax payment. However, if the personal income tax paid abroad is less than the personal income tax calculated in Latvia, the taxpayer must pay into the state budget the difference between the personal income tax to be paid in Latvia and the one paid abroad. Likewise, the courts have interpreted correctly the purpose of tax conventions. The purpose of intergovernmental tax conventions is to avoid double taxation but, at the same time, to prevent tax evasion.⁵⁷

Special regulation has been established for savings income.⁵⁸ PIT, calculated in Latvia, is decreased by the whole tax for savings income that has been paid abroad. The tax administration's obligations include also the duty to reimburse to the actual owner of the savings income the amount by which the tax from savings income calculated abroad exceeds the tax calculated in Latvia. If apart from collecting the tax on savings income also tax from other income has been deducted then, first of all, the credit method with respect to other income is applied.⁵⁹

3.2. Avoidance of Double Taxation in Case of Applying Enterprise Income Tax

3.2.1. Avoidance of Double Taxation by Relief and Credit Method

On July 28 2017, the new Enterprise Income Tax Law (hereinafter – EITL) was adopted. The period of transition to the new legal relationship ended on 1 July 2018. In accordance with the law, the enterprise income tax (hereinafter – EIT) is not levied to enterprise income (profit) until the moment of distribution of profit or channelling the profit for such expenditure that does ensure further economic development of the payer of EIT; i.e., the application of EIT has been transferred from the moment of gaining the profit to the moment of distribution thereof.⁶⁰

The rate of EIT has established in the amount of 20%. In defining the taxable base for EIT, the value of the object, to which EIT is applied, first of all is divided by the coefficient 0.8.⁶¹ Only after this the EIT rate of 20%, referred to above, is applied to the obtained value. The payment of EIT is a final payment into the state budget and another income tax is not applied to the disbursed dividends.⁶² The calculations made by economists show that the payment of EIT, introduced in following the

⁵⁷ Administratīvās apgabaltiesas 2017. gada 14. novembra spriedums lietā Nr. A420277316 [Judgement of 14 November 2017 by the Administrative Regional Court No. A420277316], archive number of the case No. AA43-1117-17/16, ECLI:LV:ADAT:2017:1114, A420277316.2.S, para. 15. Available: <https://manas.tiesas.lv/eTiesasMvc/lv/nolemumi> [last viewed 20.04.2019].

⁵⁸ With respect to the special tax, which the Member States of the European Union, territories linked to and dependent on them, states, which are not Member States of the European Union but with which the European Community has concluded international agreements, binding upon Latvia, on taxing savings income, deduct from the savings income, in order for Latvia to ensure implementation of Directive 2003/48/EC on taxation on savings income in the form of interest payments.

⁵⁹ On Personal Income Tax, art. 24.5–6.

⁶⁰ Enterprise Income Tax Law, art. 4.

⁶¹ *Ibid.*, art. 4.9.

⁶² See On Personal Income Tax, art. 9.1,2.^{1–2}.

model of the Republic of Estonia, should improve Latvia's economic indicators.⁶³ The coming years will show whether this, indeed, is the case.

With EITL coming into force, economic double taxation of commercial activities that existed previously was formally prevented. Until 31 December 2017, EIT with the rate of 15% was applied to an enterprise's income of the taxation year⁶⁴ and PIT in the rate of 10% was applied to the dividends disbursed to natural persons⁶⁵.

Pursuant to EITL, a taxpayer has the right to reduce the amount of dividends to be included into the taxable base of the taxation period by the dividends disbursed by another person and disbursements equal to dividends, as well as income received in a monetary or another form from a permanent establishment (hereinafter all income – dividends). If the amount of dividends received in the taxation period exceeds the amount of calculated dividends, the difference can be transferred to the future taxation periods (in chronological order), reducing the amount of dividends to be included in the taxable base. The right to reduce the taxable base applies only to those dividends, from which, in the residence country of the disbursement thereof, the enterprise income tax has been paid or tax has been deducted but the taxable income has not been reduced.⁶⁶

In Latvia, prior to the tax reform of 2018, a slightly different approach was taken to deduction of dividends to be received by companies. In calculating the taxable income, it was reduced by the sum of received dividends (dividend-received-deduction). This approach has a similar economic effect but there was no relief from the payment of the tax. Hence, it was not delimited by mechanisms against tax evasion.

If double taxation has not been avoided by the relief method then the taxpayer has the right to reduce the tax on dividends, calculated in the taxation period, by the amount that is equal to the tax paid abroad. To have the right to apply the credit method to income abroad, the taxpayer needs documents approved by the foreign institution that collects taxes, indicating the taxable income and the amount of the tax paid abroad. The reduced amount may not exceed the amount that would be equal to the tax on dividends from income gained abroad that has been calculated in Latvia.⁶⁷

Moreover, EITL law applies tax relief to capital gain⁶⁸ and the income received from publicly traded securities through a financial intermediary. Thus, a taxpayer has the right to reduce the amount of dividends included in the taxable base in the taxation period in the scope, in which the taxpayer, within the taxable period, has gained income from alienation of direct participation shares, the holding period of which at the moment of alienation had been at least 36 months. Whereas to reduce the calculated tax on dividends, upon receiving publicly traded dividends thro is

⁶³ *Prohorovs, A. Uzņēmumu ienākuma nodoklis Latvijā un Igaunijā: tā ietekme uz uzņēmējdarbību, investīcijām, bezdarba līmeni, nodokļu ieņēmumiem un valsts ekonomisko izaugsmi* [Corporate Income Tax in Latvia and Estonia: Effects on Entrepreneurial Activity, Investment, the Unemployment Rate, Tax Revenues and the Economic Growth of the State] (2017). Available: <http://dx.doi.org/10.2139/ssrn.2916437> [last viewed 20.04.2019].

⁶⁴ Par uzņēmumu ienākuma nodokli [On Enterprise Income Tax], art. 3.1 (09.02.1995). Available: <https://likumi.lv/doc.php?id=34094> [last viewed 20.04.2019].

⁶⁵ (See the wording of the law until 31.12.2017) On Personal Income Tax, art. 15.3¹.

⁶⁶ Enterprise Income Tax Law, art. 6, 15.4–6.

⁶⁷ *Ibid.*, art. 15.1–2.

⁶⁸ *Ibid.*, art. 13.

required.⁶⁹ Likewise, the Latvian tax administration should be able to identify the true beneficiary and the respective securities, from which the income had been paid, from the submitted documents.

In drafting EITL, the legislator has thought also about prevention of tax evasion. As a tax evasion prevention norm, the provision is included that the EIT taxable base may not be reduced by the dividends received from tax havens⁷⁰, a payer of micro-enterprise tax⁷¹ or an investment fund / alternative investment fund⁷², i.e., persons with a different regime of tax application.

3.2.2. The Case of Transfer Pricing

Another situation of economic double taxation is the case of adjusting transfer pricing. For example, one state increases the taxable income in accordance with price adjustment in transactions with related persons; however, corresponding adjustments with respect to the transaction prices of a related person do not follow in the other state. As the result, the profit from a transaction between related persons is taxed twice.

Pursuant to EITL section 4, for taxpayers the taxable base of EIT is formed by aggregating the objects calculated in Latvia and abroad in the taxation period. These objects include income that the taxpayer would have received or expenditure that the taxpayer would have incurred if the commercial or financial relationships had been created or established in accordance with the rules in force between two independent persons, i.e.; the value of concluded transactions must correspond to the market price (value).

This case of economic double taxation is avoided by using the regulation of conventions that allows distributing the right to tax between two countries. The sources of international legal regulation on transfer prices are the OECD Model Tax Convention and the UN Model Tax Convention. The tax conventions concluded by Latvia also include article 9 on defining the principle of transactions between unrelated enterprises and the basic principles of profit adjustment and article 25, which contains a reference to the Mutual Agreement Procedure (MAP) as a mechanism for dispute resolution in the case of establishing transfer prices.⁷³

⁶⁹ A document, issued to the financial intermediary by the tax collection institution in a Member State of the EU or a state, with which Latvia has concluded a convention on avoiding double taxation and tax evasion and the convention has entered into effect or an agreement on exchanging tax-related information, is considered as being such a statement. If the financial intermediary is a resident of the states referred to above then it is enough to have a statement by the financial intermediary itself on payment of taxes abroad. See Enterprise Income Tax Law, art. 15.7–8.

⁷⁰ Dividends, which are disbursed by persons, which have been created or established in states or territories of low taxes or no taxes, are considered to be dividends of ‘tax havens’. Such states and territories are enumerated in Latvia’s so-called ‘blacklist’. See Par zemu nodokļu vai beznodokļu valstīm un teritorijām [On Low Tax or No Tax States and Territories] (07.11.2017). Available: <https://likumi.lv/ta/id/294935> [last viewed 20.04.2019].

⁷¹ The micro-enterprise tax is paid from the enterprise’s turnover. See Mikrouzņēmumu nodokļa likums [Micro-enterprise Tax Law] (09.08.2010). Available: <https://likumi.lv/doc.php?id=215302> [last viewed 20.04.2019].

⁷² Enterprise Income Tax Law, art. 6.

⁷³ See for instance Convention between the Republic of Latvia and the Republic of Austria for the avoidance of double taxation with respect to taxes on income and on capital; Agreement between the Republic of Latvia and the Federal Republic of Germany for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital; Par Latvijas Republikas un Japānas konvenciju par nodokļu dubultās uzlikšanas attiecībā uz ienākuma nodokļiem, ļaunprātīgas izvairšanās no nodokļu maksāšanas un nodokļu nemaksāšanas novēršanu [Convention between

The Arbitration Convention operates in the EU law.⁷⁴ Pursuant to its article 14, the double taxation of profits is regarded as eliminated, if the profits are included in the computation of taxable profits in one state only, or if the tax chargeable on those profits in one state is reduced by an amount equal to the tax chargeable on these in the other. The risk of double taxation in the case of transfer prices, basically, can occur in situations, where the taxpayer, upon establishing non-conformity of a transfer price with the market price, adjusts its taxable income. To avoid occurrence of double taxation (taxation in each country of the taxpayers), the conventions concluded by the states have included the second part of article 9, following the OECD Model Tax Convention, which provides “the other State must introduce corresponding changes with respect to the amount of tax charged on this profit in the other State”. One of the most authoritative international sources in the area of transfer prices, which is used by states, attempting to introduce in their national regulatory enactments legal regulation on transfer prices (including the requirements regarding the documentation of transfer prices), is the OECD document “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”⁷⁵ (OECD Guidelines on Transfer Pricing). In July 2017, thanks to OECD/G20 Project on Base Erosion and Profit Shifting Action Plans, the Guidelines were substantially revised⁷⁶. The Guidelines comprise both general principles and practical references to methods to be applied to a transaction and on preparing documentation, and currently this is the only regulation of practical significance that is used in determining transfer prices. The Guidelines have been used also in working out the Latvian practical application of transfer prices.⁷⁷ Thus, the impact of this type of economic double taxation is decreased.

the Republic of Latvia and Japan for the elimination of double taxation with respect to taxes on income and the prevention of tax evasion and avoidance] (30.03.2017). Available: <https://likumi.lv/doc.php?id=289934> [last viewed 20.04.2019]. etc.

⁷⁴ Konvencija par nodokļu dubultās uzlikšanas novēršanu sakarā ar asociēto uzņēmumu peļņas korekciju Nr. 90/436/EEC [Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises No. 90/436/EEC]. Available: <https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A41990A0436> [last viewed 20.04.2019].

⁷⁵ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017. OECD Publishing, Paris. Available: <http://dx.doi.org/10.1787/tpg-2017-en> [last viewed 20.04.2019].

⁷⁶ Ibid.

⁷⁷ “Regulation on Applying the Norms of the Enterprise Income Tax Law” allow using OECD Guidelines as a supplementary source of law and provide that, insofar it is not contrary to the rights and obligations of the taxpayer and the tax administration defined in regulatory enactments, the document of the Organisation of Economic Co-operation and Development “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” may be used as a supplementary source to apply the techniques for determining the market prices (values) of transactions (the market price (value) of goods (product), service, intangible property or another object of transaction) and techniques of economic analysis referred to in paragraph 9, 13, 14, 15, 16 and 17, to perform the functional analysis and the analysis of comparability in accordance with paragraphs 8, 9, 10, 11 and 12 of this Regulation, to facilitate cooperation between a taxpayer and the tax administration, and to avoid double taxation; to substantiate the economic essence of specific controlled transactions (services, agreements on cost investments, transactions with intangible property, restructuring) and to document these. See Uzņēmumu ienākuma nodokļa likuma normu piemērošanas noteikumi [Regulation on Applying the Norms of the Enterprise Income Tax Law] (14.11.2017). Available: <https://likumi.lv/ta/id/295416-uznemumu-ienakuma-nodokla-likuma-normu-piemerosanas-noteikumi> [last viewed 20.04.2019].

Summary

1. Latvia addresses the issue of avoiding double taxation in the area of income tax in compliance with the international commitments and the OECD recommendations in the area of avoiding double taxation; i.e.: by the methods of residence tiebreaker, relief and credit. The procedure for establishing transfer prices is a special case.
2. The Latvian courts interpret the relief method as a special method (special norm) with respect to the credit method for avoiding double taxation. Therefore, the relief method is applicable only with respect to types of income particularly defined in the law and is not applicable by analogy.
3. The purpose of methods for avoiding double taxation is incompatible with tax evasion. Therefore, the so-called anti-avoidance / anti-evasion norms have been integrated into the Latvian tax laws to prevent a situation where income taxes are not paid altogether.

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