"THIN CAPITALIZATION RULES IN LATVIA: SHOULD THE BOUNDARIES BE CHANGED?"

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I Introduction

Latvian thin capitalization rules were adopted in 2003 and have been amended several times since then. However, these rules have never been a priority of the Latvian government – it had focused on other issues considered more important for tax revenue purposes.

In the meantime, the European Court of Justice (ECJ) has shaped the understanding of thin capitalization rules in the context of the European Community (EC) Treaty. Several decisions of national courts have been adopted on thin capitalization rules concerning double tax treaties. There have been ongoing discussions regarding the best method to calculate the excessive and disallowable interest in situations where a company is thinly capitalized. As a result of these developments, many European Union (EU) Member States have reconsidered, amended or abolished their thin capitalization provisions.

The aim of this paper is to analyse the current Latvian thin capitalization rules in the light of the developments in the Europe and international tax area and identify any shortcomings that should be rectified in order to make their application more effective for both the state and taxpayers. The paper intends to initiate further discussion of these shortcomings despite the fact that an exhaustive list of solutions cannot be provided at this time.

The paper will be structured as follows. Chapter II of the paper describes how thin capitalization rules work and explains why these rules might be important in a low tax country like Latvia. Chapter III provides a brief summary of the current Latvian thin capitalization provisions. A detailed analysis of Latvian thin capitalization provisions is to be found in Chapter IV of the paper. This Chapter is divided into

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three parts: the first analyses how the provisions apply to particular persons in the light of non-discrimination concepts developed in the international and the EC tax area; the second focuses on the methods for determining the amount of excessive interest; the final part examines several concepts and definitions used by Latvian thin capitalization provisions. The concluding Chapter summarizes the analysis.

II Thin Capitalization Provisions in General

This chapter describes how thin capitalization rules work and answers the question why thin capitalization rules might be important to a low tax country.

1. How thin capitalization rules work

1.1 Thinly capitalized entities

Generally, it can be said that a company is thinly capitalized when it has a high proportion of debt capital in relation to its equity capital. In other words, thin capitalization is a result of financing a company by way of excessive debt. Usually, excessive debt financing can be observed between related parties operating either within one jurisdiction or across borders.

Debt financing can be preferred over equity investments due to commercial or financial reasons. However, sometimes a decision to lend a large amount of money to a foreign company can be driven purely by tax incentives since in most countries interest is an allowable deduction, whereas dividends are not. This means that the transfer of interest across borders can reduce the tax liabilities of the borrower and, if the parties are related, of the whole group. Another incentive is withholding tax rates. Withholding tax is usually lower for interest than dividends, should the tax for interest be withheld at all.[2]

1.2 Thin capitalization rules

Many countries have adopted thin capitalization rules. Usually, these rules are implemented into domestic tax laws of a country. Their aim is to prevent tax abuse and diminution of tax receipts of a source country. This aim is achieved, generally, by disallowing the borrower to deduct the interest if it exceeds certain thresholds and levying tax on this amount.

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2 Reasons why thin capitalization rules can be attractive to taxpayers are described in many sources, which deal with particular thin capitalization problems. See, for example: The OECD Report (1986); Avery Jones, J.F. (1996) p. 226; Stroud, A., Masters, C. (1991), pp. 56-57; Davis, C. G., Gunson, D. (ed.) (1995-), S.10.182; Brokelind, C. (2004), pp. 181-182 etc.

In brief, thin capitalization rules regulate how taxpayers and tax authorities must determine the amount of excessive and disallowable interest and stipulate its tax treatment.

Countries have adopted different methods for determining the amount of excessive interest. Some countries apply several approaches instead of a single one. For example, the amount of excessive interest can be determined using the arm's length approach. This allows the amount of the loan or the level of commercial interest rate that would have been charged between independent parties in an uncontrolled transaction.[3] This approach is used in the United Kingdom and Italy.

Other countries like the Netherlands and Germany[4] use a fixed statutory debt to equity ratio or "safe harbour" approach. Put simply, this approach envisages that interest for a loan exceeding the "safe harbour" ratio cannot be deducted.

Another method to determine the excessive debt financing is to apply the "substance over form doctrine" which requires deciding whether the real nature or substance of the transaction is debt or equity investment. This option, again, is used in the United Kingdom.

Usually, the excessive interest is disallowed. As to the further tax treatment, Belgium, France and the Netherlands charge an interest withholding tax for the excessive amount, whereas Switzerland and Czech Republic re-characterize the excessive amount as a dividend and apply the dividend tax treatment thereto.

Besides the thin capitalization methods described above, the legislation of each particular country may contain additional provisions that expand or, conversely, restrict the applicability of these methods. For example, such provisions may restrict the applicability of the methods to related parties or other specified persons. The legislation of some countries may also provide guidance for tax authorities and taxpayers how to distinguish between equity investments and loans.

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3 The International Bureau of Fiscal Documentation (IBFD), International Tax Glossary (2005), p. 23

4 Note that German thin capitalization rules are changed significantly starting from 1 January 2008. Since then, Germany implemented so called "interest barriers" (*Zinsschranke*). Reference to German thin capitalization rules in the above context is reference to the German rules before 1 January 2008.

2. Importance of thin capitalization rules to a low tax country

2.1. Relationship between low tax rate and the need for thin capitalization rules

It is fair to say that thin capitalization is not the issue that is foremost in the minds of Latvian tax authorities. Since Latvia has a very low corporate income tax rate of 15 per cent, profits are more likely to be imported into Latvia than exported out of the country.[5] A recent research shows that the relative benefit of debt over equity financing increases along with increase of the tax rate.[6]

2.2. Importance of thin capitalization rules in a low tax country

There are several good reasons why thin capitalization rules should be well designed and applied to cross-border transactions, even if the corporate income tax rate of a country is low. Tax authorities of such a country might wish to consider the following arguments.[7]

First, thin capitalization rules can be used to prevent artificial debt financing structures and thus maintain the fair allocation of taxing rights between the source country of interest and the residence country of the recipient. Should entities be not bound by thin capitalization rules, they might be keen to opt for debt over equity financing because of the tax benefits favouring interest (deductible) over dividend (non-deductible) payments. Besides, there are many countries, e.g. so-called tax havens, with a more favourable corporate income tax regime that would encourage entities to structure transactions in their direction and reduce tax liabilities in countries like Latvia.

Second, poor thin capitalization rules might disturb the flow of interest and cash where there are good commercial reasons for granting an excessive loan.[8] Sometimes the grant of a loan to a related party in another country is preferred over equity investment because of its flexibility. For example, because debt can be repaid at any time, but share capital can only be returned in accordance with complex

5 Kronbergs, Z.G. (2005), p. 407

6 Devereux, M. (2006), p. 1

7 Some of these arguments are taken from the OECD Report (1986), p. R(4) 9-10

8 This argument has to be seen in the light of rather recent ECJ decisions, in particular *Cadbury Schweppes* and *Thin Cap GLO,* where the ECJ decided that restrictions to the EC Treaty freedoms may be justified on grounds of prevention of tax avoidance and only when they apply to “wholly artificial arrangements”. According to these cases, it can be contested that thin capitalization rules of an EU Member State are contrary to the EC Treaty if they prohibit deduction of excessive interest where a loan has an underlying commercial justification. However, this discussion goes beyond the scope of this paper.

procedures stipulated by company law or on a winding up.[9] Thin capitalization rules have to be fair and flexible and allow judgement on a case-by-case basis – commercial environment with fair rules will make business environment more attractive.

Third, clear thin capitalization rules may promote foreign investments. It is said that in financing decisions tax factors follow political stability, clarity of outcomes, and access to good quality services.[10] Nevertheless, clear tax rules can make the investment environment more transparent and predictable. An investor will be more interested in investing in a country with well-elaborated thin capitalization rules that enable him to predict his future tax liabilities.

III Latvian Thin Capitalization Provisions

This chapter summarizes the main provisions of the Latvian thin capitalization rules. The first part is a brief overview of the adoption history of these rules. The second part lists the persons bound by the thin capitalization rules. The third part describes the methods used to determine the amount of excessive and disallowable interest. Finally, the last part of this chapter makes a few applicability assumptions about the thin capitalization rules. These assumptions create the background for the analysis of these rules in the Chapter IV, where the thin capitalization provisions are discussed in detail.

1. Adoption history of Latvia's thin capitalization rules

Latvia introduced thin capitalization rules in 2003. Rules are stipulated in Article 6.4 of the Corporate Income Tax Law (hereinafter – CITL) and several articles of the Cabinet of Ministers Regulations No 556 (of 4 July 2006) on Application of CITL (hereinafter – CITL Implementing Provisions). Article 6.4 of CITL has been amended and the amendments entered into force on 1 January 2006 and 2007.

2. Persons bound by Latvian thin capitalization rules

Generally, thin capitalization rules apply to "a taxpayer", as defined by Article 2 of the CITL. Although the definition is quite broad, for the purposes of further analysis it can be summarized as follows: a taxpayer is –

(a) a resident of Latvia (a company or other type of a corporate body with legal personality, incorporated in Latvia) performing economic activity there;

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9 Southern, D. (2007), p. 7

10 Devereux, M. (2006), p. 34

(b) an institution financed by the state or municipality, performing economic activity, whose income is not provided for in the state budget;

(c) a non-resident (a foreign commercial company, natural person and other persons) or its permanent establishment.

CITL provides that pension funds, partnerships, associations, foundations, political parties, religious organisations and several other persons are not regarded as taxpayers for the purposes of this law.

Several taxpayers are exempted from the thin capitalization provisions under Article 6.4 of the CITL. These are credit institutions and insurance companies. Similarly, the provisions do not apply if the recipient of the interest is a non-resident. There are other persons exempted from the scope of thin capitalization rules. However, these other exemptions do not raise any problem questions and, therefore, are not discussed in more detail.

Analysis of these provisions is provided in Chapter IV (Part 1) of this paper. It discusses the compatibility of the provisions with the EC Treaty[11], the Agreement on the European Economic Area (hereinafter – the EEA Agreement) and Latvian double tax treaties. As a result, it reveals several insufficiencies of the provisions when applied to credit institutions and partnerships.

3. Methods to determine excessive interest

As noted above, the excessive interest is disallowed and is not reclassified as dividends. That is, the tax treatment of dividends is not applied when the excessive interest is distributed across borders. The disallowed interest cannot be carried forward and is, therefore, considered as lost for deduction purposes. This raises the question of how to determine the excessive interest?

Article 6.4 of the CITL provides that an excessive interest can be determined according to the following three methods:

(a) a formula approach;

(b) a debt to equity ratio method; and

(c) a general anti avoidance method focusing on the substance rather than the form of the transaction.

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11 Treaty concluded in Rome, 25 March 1957, establishing the European Community, as amended by the Treaty on the European Union Concluded in Maastricht, on 7 February 1992 and entered into force on 1 November 1993. The Treaty was further amended by the Treaty on the European Union concluded in Amsterdam on 2 October 1997 and entered into force on 1 May 1999.

Although not listed in Article 6.4. of the CITL, the author of this paper submits that an arm's length approach could also be used for determining the amount of excessive interest. The arm's length approach is generally used for determining the price of a transaction between related parties. Since interest can be regarded as the fee (or price) paid on borrowed money, arm's length principles could, by analogy, be used to determine the interest between related parties. However, as the thin capitalization provisions do not refer to this approach explicitly, it will not be discussed in more detail.

The following three sub-parts summarize the key points of each method used for determining the amount of the excessive interest. Finally, the fourth sub-part provides guidance as to which method should be applied in particular circumstances.

3.1 Formula approach (CITL, Article 6.4 (1))

According to the formula approach, the excessive interest is determined by calculating the surplus between the actual interest rate applied to the loan transaction and the interest rate calculated by multiplying 1.2 times the average short-term credit rate applicable to credit institutions in Latvia within the last month of a particular taxation period. For example, if the tax year of a taxpayer corresponds to a calendar year the taxpayer would have to apply the formula using the average short-term credit rate applicable in December of that particular year[12].

3.2 Debt to equity ratio approach (CITL, Article 6.4(2))

Excessive interest can be determined by applying the debt to equity ratio approach in the following way. First, the debt to equity ratio is calculated as a company's weighed average debt capital in a tax year against company's equity as stated in the accounts at the beginning of the company's tax year (as adjusted by corresponding reserves). The result is then compared to the statutory "safe harbour" ratio 4:1. The excessive interest is determined using the proportion by which the calculated debt to equity ratio exceeds the statutory ratio.

3.3 Substance over form doctrine (CITL, Article 6.4(5))

This approach was introduced by amendments to the CITL, effective from 1 January 2007. It provides that taxable income can be adjusted where the economic substance indicates that the payment is not interest. Since interest payments are treated more favourably than dividends, it is most likely that the substance over form method would be used by tax authorities rather than taxpayers.

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12 Rates announced by Latvian State Revenue Service, letter No 151.2-9/5137 of 31 January 2007; for example, in December of 2006 these rates were 5.6 per cent for funds borrowed in euros, 7.6 per cent for funds borrowed in Latvian lats and 10.1 per cent for US dollars.

Currently, there is no further guidance in the CITL on the criteria to be used when applying this method for determining the economic substance of payments. Neither has any such criteria been established in practice due to the relatively recent implementation of the method. It has to be noted that prior to these amendments the thin capitalization provisions in Latvia did not provide that transactions could be judged by the substance of the payment.

3.4 Applicability of the methods

The CITL does not expressly allocate the application of each of the three methods to specific cases. It seems that taxpayers and Latvian tax authorities can freely choose between the substance over form doctrine and the two other methods to determine the excessive interest. However, as noted above, it is most likely that only the tax authorities will select the substance over form doctrine due to its anti-avoidance characteristics.

Therefore, in most cases, taxpayers will opt for either the formula approach or the debt to equity ratio approach. However, with respect to these two methods the freedom of choice is limited by Article 6.4(3) of the CITL which requires that the method resulting in a larger amount of taxable income should be used. The CITL Implementing Provisions contain several specific technical rules on how such calculations have to be made.

As mentioned above, neither the formula approach nor the debt to equity ratio approach apply to credit institutions, insurance companies or to

> "*interest payments for credits, leasing services and loans received from credit institutions registered in the Republic of Latvia or another Member State of the European Union, State Treasury of the Republic of Latvia, Nordic Investment Bank or from World Bank Group, as well as from Latvian residents*." (CITL, Article 6.4 (4))

The four methods described above are analysed in more detail in Chapter IV (Part 2).

4. Applicability assumption

The author of this paper considers that, although not explicitly stated, it is a valid assumption of the CITL that its thin capitalization provisions are applicable mainly where an associated or related party provides a loan, directly or indirectly. The CITL does not limit the application of thin capitalization rules to related parties only. Nevertheless, as noted above, the aim of the thin capitalization rules is to prevent companies from financing their affiliates in a more tax beneficial way[13] and so

13 The OECD Report (1986), p.R(4) 3

preserve country's income tax base. Besides, excessive debt financing is most likely to be present only where special relationships between the borrower and the lender exist.[14] The further analysis of thin capitalization rules in Chapter IV will, therefore, mainly discuss transactions that involve related parties.

The CITL's approach may, nevertheless, be a wise choice because thin capitalization rules will thus apply to all excessive loans and will cover loans between related and unrelated persons. It would also cover such problematic situations where a related party guarantees repayment of the loan granted through an unrelated party.[15]

The CITL's approach also helps avoiding the problem of defining the persons who can be considered as related. Such problems arose, for example, in the United Kingdom, when tests applicable to related parties in determination of arm's length price led to discussions regarding applicability of the rules to particular persons, for example, to partnerships. It was argued that partners of a partnership taken individually do not fulfil the "control test"[16] which is a prerequisite to regard persons as related and to apply the arm's length principles.

IV Analysis of Latvian thin capitalization rules

This chapter contains a substantive analysis of Latvian thin capitalization provisions. The first part examines problems arising from application of the rules to certain groups of persons. The second part is an in-depth study of the methods used to determine the excessive interest and highlights weak points of these methods. Finally, the third part picks out several problems arising from the wording of the thin capitalization provisions. Each part ends with conclusions regarding the changes needed to improve the identified problematic areas.

1. Problem questions of Latvian thin capitalization rules in relation to persons concerned

Thin capitalization provisions apply only to limited groups of persons. Further analysis below shows that thin capitalization provisions can be regarded as discriminatory (sub-part 1.1) and that they are ambiguous when applied to partnerships and credit institutions (sub-part 1.2).

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14 Shelton, N. (2004), p. 527

15 It has to be noted that this rule will not apply where a bank and several other persons, named explicitly by the CITL, provide a loan (CITL, Article 6.4(4)).

16 Casley, A., Webb-Martin L. (2005), p. 139

1.1 Discriminatory treatment according to Latvian thin capitalization rules

Latvian thin capitalization rules are discriminatory when interest is transferred across borders. This is because these rules apply only when interest is paid to a non-resident (EU/EEA or resident of a third country[17]), whereas they do not apply when the recipient of interest is a Latvian resident.[18] Thus, in most situations[19], only non-resident subsidiaries will be subject to the unfavourable consequences of the thin capitalization regime.

The EC Treaty, the EEA Agreement and several of Latvia's double tax treaties prohibit discriminatory treatment. Further analysis explains, first, the incompatibilities of Latvian thin capitalization rules with the EC Treaty/EEA Agreement (part 1.1.1). Then, it discusses the incompatibilities of the rules with Latvian double tax treaties (part 1.1.2).

1.1.1 Discriminatory treatment according to the EC Treaty/EEA Agreement

a) Freedoms of the EC Treaty/EEA Agreement and their interpretation

According to the Article 43 of the EC Treaty, restrictions on the freedom of establishment of nationals of EU Member State in the territory of another EU Member State shall be prohibited. Article 48 of the EC Treaty provides that companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community should be treated in the same way as natural persons who are nationals of Member States. Article 48 explains further that "companies or firms" means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.

Similar provisions are included in Articles 31 and 34 of the EEA Agreement. These provisions apply to all EEA Member States, i.e. 27 EU Member States, Norway, Iceland and Liechtenstein.

The ECJ and EFTA courts have interpreted both the EC Treaty and the EEA Agreement and made it clear that the EEA fundamental freedoms and the EC

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17 A country which is not a Member State of the European Union and a member of the European Economic Area.

18 Interestingly, this particular provision was implemented into CITL amendments just before the law went through its final revision and approval by Saeima (Latvian legislative body) in December 2006 and entered in force on 1 January 2007.

19 As mentioned before, for the purposes of this paper it is assumed that Latvian thin capitalization rules apply to related parties (please see Chapter III, Part 4 for details).

fundamental freedoms are identical in substance and will be applied in the same way throughout the European Economic Area.[20]

Several ECJ cases have established that in the case of thin capitalization of a foreign subsidiary it is most likely that freedom of establishment will be applicable. For example, in *Thin Cap GLO* the ECJ found that

> *"(..) national provisions which apply to holdings by nationals of the EU Member State concerned in the capital of a company established in another Member State, giving them definite influence on the company's decisions and allowing them to determine its activities, come within the substantive scope of the provisions of the EC Treaty on freedom of establishment.*"[21]

Although the provisions of Latvian thin capitalization rules differ from those previously analysed by the ECJ, it is most likely that the freedom of establishment will apply to relationships affected by Latvian thin capitalization rules. Moreover, it is unlikely that other EC Treaty/EEA Agreement freedoms (free movement of capital, in particular) will prevail over the freedom of establishment when thin capitalization rules are concerned[22]. However, the discussion regarding applicable freedoms will not be expanded further in more detail, as this goes beyond the scope of the paper.

b) Different treatment of Latvian insurance companies and EU/EEA insurance companies

CITL provides that thin capitalization rules do not apply to insurance companies. Initially, it seems that this exclusion applies to both Latvian and EU/EEA companies, however the Law on Insurance Companies suggests that only Latvian insurance companies are covered. This derives from the following.

The meaning of "an insurance company", as it is used by the CITL, has to be determined in accordance with the Law on Insurance Companies. This law defines that "an insurance company" is a resident of Latvia only, namely - a company incorporated in Latvia[23]. Therefore, only insurance companies incorporated in Latvia

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20 Gudmundsson, J. E. (2006), p. 58

21 *Thin Cap GLO*, paragraph 27, see also: *Baars*, paragraph 22; *X and Y*, paragraph 37; *Cadbury Schweppes*, paragraph 31. See, also: O'Shea, T. (2007), pp. 1-5

22 According to the recent *Holböck* case (C-157/05, paragraph 22) the purpose of the restrictive provisions have to be taken into account to determine whether a particular national rule restricts the freedom of establishment or the free movement of capital.

23 Article 1(3)a of the Law on Insurance Companies of 10 June 1998, as amended (publ. in the Official Gazette "Latvijas Vestnesis" No 188/189, dated 30 June1998)

are exempt from the thin capitalization rules, whereas all other insurance companies have to apply these provisions.

The Law on Insurance Companies provides that any EU insurance company is allowed to commence its business in Latvia without incorporation. It is most likely that for tax purposes an EU insurance company will choose to carry out its business activities in the form of a permanent establishment (e.g. a branch). Generally, permanent establishments calculate their taxable income in a similar way to residents. However, the thin capitalization rules will apply to permanent establishments only. It can be said, therefore, that non-resident EU insurers are forced to incorporate subsidiaries in Latvia in order to escape thin capitalization rules.[24]

This situation can be compared to the *Avoir Fiscal* case, where it was held that Article 43 of the EC Treaty is intended to ensure that a company of one Member State may choose the form of establishment to operate in another Member State and receive the same treatment as nationals of that state and it prohibits, as a restriction on freedom of establishment, any discrimination on grounds of nationality resulting from the legislation of the Member State.[25] The ECJ decision in *Halliburton* can be mentioned here as well. In this case a German company transferred and sold to its Dutch sister company its permanent establishment in the Netherlands, which included immovable property. In the Netherlands the transfer of immovable property was subject to the tax on legal transactions. However, the transactions were exempt if carried out as part of an internal reorganization of public limited companies and private limited companies. The ECJ decided that

> *"(..) the vendor is in a distinctly less favourable position than if it had chosen the form of a public or private limited company instead of that of a permanent establishment for its business in the Netherlands. Although the difference in treatment has only an indirect effect on the position of companies constituted under the law of other Member States, it constitutes discrimination on grounds of nationality which is prohibited by Article 43 of the Treaty."*[26]

Similarly, Latvian insurers can contest that the requirement to incorporate subsidiaries in Latvia in order to escape thin capitalization rules is contrary to Article 43 of the EC Treaty. It can be said that insurance companies of other

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24 Theoretically, it can be contested whether it is reasonable to apply thin capitalization provisions to a permanent establishment of a non-resident at all, because there cannot be an alternative "equity" investment as such. However, this discussion is outside the scope of this paper.

25 *Avoir Fiscal,* paragraphs 13 and 14

26 *Halliburton*, paragraphs 19 and 20

Member States are deprived of one element of the freedom of establishment, namely, the freedom to choose the form of an establishment. As Lord Scott of Foscote explained in the UK's *Pirelli* case

> "*the right to freedom of establishment conferred by article [43] is the right of a company (or an individual) with its seat in one member state to establish itself in another member state. Unwarranted restrictions imposed by the latter member state on the branch or agency or subsidiary company by means of which the parent company is seeking to establish itself in that member state is plainly a breach of the (..) right to freedom of establishment of that parent company.*"[27]

Similarly, no restrictions to the freedom of establishment are allowed under Article 31 of the EEA Agreement, thus insurance companies of Norway, Liechtenstein and Iceland also cannot be discriminated against.

To conclude, the CITL has to clarify which insurance companies are subject to the thin capitalization provisions. CITL should be amended to comply with the EC Treaty and the EEA Agreement.

c) Different treatment of a Latvian subsidiary and EU/EEA subsidiary

Latvian thin capitalization provisions apply if Latvian resident distributes interest to its EU/EEA parent. The provisions do not apply, if the recipient is Latvian resident. As mentioned before, the tax treatment has to comply with the EC Treaty or the EEA Agreement, namely - comparable persons should be treated equally.

The situation arising from this treatment is very similar to the *Lankhorst-Hohorst* case decided by the ECJ several years ago, where German thin capitalization rules were found to be incompatible with Article 43 of the EC Treaty. German legislation introduced tax treatment that differentiated between resident subsidiary companies according to whether or not their parent company had its seat in Germany. In particular, interest payments for a loan provided by a non-resident parent were treated as covert distribution of profits and taxed more heavily than interest payments for a loan provided by a domestic parent company. The ECJ found this as incompatible with the EC Treaty.[28]

Similarly, Latvian thin capitalization provisions do not apply if interest is paid to a resident parent. In turn, the rules should be applied when interest is paid to a non-resident parent. Several other authors have noticed correctly that this is incompatible

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27 *Pirelli Cable Holding NV and others v. Inland Revenue Commissioners* [2006] 1 WLR 400, paragraph 77

28 *Lankhorst-Hohorst*, paragraph 32

with the EC Treaty.[29] It is also the opinion of this author that these rules are contrary to the EEA Agreement.

To conclude, the CITL provisions should be amended to comply with the EC Treaty and the EEA Agreement.

1.1.2 Discriminatory treatment according to double tax treaties

Latvian thin capitalization provisions apply when Latvian resident distributes interest to its third country parent. On the contrary, these provisions do not apply if the recipient is a Latvian resident. Such different treatment can be found to be incompatible with a double tax treaty, if such a treaty between Latvia and a third country includes a non-discrimination clause. The following paragraphs explain this in more detail.

a) Non-discrimination clause of double tax treaties

Most Latvian tax treaties follow the Model Convention of the Organization for Economic Co-operation and Development (hereinafter – OECD). Generally, the non-discrimination clause (Article 24) of the OECD Model Convention provides that companies of one contracting state should not be subjected in the other contracting state to any taxation which is other or more burdensome than the taxation to which companies of that other state in the same circumstances are or may be subjected.[30]

More specifically, with regard to interest deductibility and thin capitalization provisions paragraphs 4 and 5 of Article 24 of the OECD Model Convention should be taken into account. Article 24(4) provides that, except where the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 apply, interest paid by a resident of one contracting state to a resident of another contracting state shall be deductible under the same conditions as if it had been paid to a resident of the first state. This means that the country of the borrower can treat interest as a dividend under its domestic rules on thin capitalization insofar as these rules are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. These articles aim to prevent situations where by reason of special relationship between the companies the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the recipient of the interest in the absence of such relationship.[31] As it was said above, it is most likely

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29 Aumeistere, S., Klavinska, A. (2007), WTD 22-3

30 Article 24 of the OECD Model Convention uses the expression “other or more burdensome” taxation. This expression has been interpreted by several court decisions. However, the interpretations of this expression will not be discussed in more detail.

31 Commentaries to the OECD Model Convention (2005), Article 24, paragraph 56

that thin capitalization will arise where a related party provides a loan. Thus Article 24(4) allows a country to apply thin capitalization rules to interest payment transferred abroad if the interest exceeds the amount which would have been agreed by both parties in the absence of special relationship.

In addition, paragraph 5 of Article 24 provides that the tax treatment of companies of one contracting state, the capital of which is wholly or partly owned or controlled by residents of the other contracting state should not be subjected in the first mentioned state to any taxation which is other or more burdensome than the taxation to which other similar enterprises of the first-mentioned state are or may be subjected. The Commentaries to the OECD Model Convention explain that paragraph 5, though relevant in principle to thin capitalization, is worded in such general terms that it must take second place to more specific provisions, thus, paragraph 4 (referring to paragraph 1 of Article 9 and paragraph 6 of Article 11) takes precedence over this paragraph in relation to the deduction of interest.[32]

To sum up, the above mentioned provisions, if included in a double tax treaty, allow a country to maintain thin capitalization provisions prohibiting the deduction of the interest transferred abroad if it exceeds the amount which had been paid were the parties to the transaction not involved in special relationship. However, if a treaty does not include the provisions (like paragraph 1 of Article 9 and paragraph 6 of Article 11) overriding the general non-discrimination clause, taxation of interest which is other or more burdensome than the taxation to which other similar enterprises are subjected is not allowed.

National courts in a number of cases have resolved the conflict between double tax treaty and domestic thin capitalization provisions. For example, the argument of equal treatment, when no other double tax treaty provisions prevail, was successfully defended in the French Supreme Court for Administrative Justice in the *Andritz SA* case.[33] In brief, the court held that companies have to be treated equally irrespective of their parent's residence country.

b) Different treatment of a Latvian subsidiary and a third country subsidiary

It follows that Latvian residents owned or controlled by residents of another contracting state can rely on the non-discrimination clause if they suspect that their interest payments are taxed in a more burdensome way than the payments made between two residents of Latvia. The non-discrimination clause may be overridden by another treaty provision which allows the contracting state to apply domestic thin

32 Commentaries to the OECD Model Convention (2005), Article 24, paragraph 58

33 Brokelind, C. (2004), p. 186

capitalization rules to take precedence over the general interdiction of non-discrimination.[34]

An example of a double tax treaty which does not allow national thin capitalization rules to prevail over the non-discrimination clause is the one which is concluded between Latvia and Canada.[35] This points to collision between Latvian thin capitalization rules and the tax treaty. However, research into the practice would be necessary to conclude that the discrimination takes place. Also, a more detailed analysis of Latvian double tax treaties[36] would be necessary to conclude whether Latvia and other countries have agreed that thin capitalization provisions of one country (e.g Latvia) can prevail over the non-discrimination clause of bilateral agreements between the countries. Such an analysis, however, goes beyond the scope of this paper.

1.2 Issues arising from the application of Latvian thin capitalization provisions to credit institutions and partnerships

This section shows that Latvian thin capitalization rules are not clear-cut when applied to credit institutions (discussed in more detail in 1.2.1) and that they are misleading when applied to partnerships (analysed in more detail in 1.2.2).

1.2.1 Issues arising from the application of Latvian thin capitalization provisions to credit institutions

a) The scope of thin capitalization rules should be clarified

It can be said that thin capitalization rules are not sufficiently clear with regard to credit institutions. In particular, it is not clear whether a credit institution is allowed to consider any payment for a loan granted by its parent as interest. Also, it might be the case that the substance over form doctrine applies to credit institutions. However, there is no further guidance on how a credit institution should apply this doctrine to tax calculations for interest payments when a loan is granted by another credit institution. Further paragraphs discuss the problem in more detail.

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34 Commentaries to the OECD Model Convention (2005), Article 24, paragraph 58; an example of the derogation clause can be found in Article 24 (4) of the OECD Model Convention. Examples of such articles can be found in several double tax treaties concluded between states.

35 Namely, this treaty contains a non-discrimination article which is similar to Article 24(5) of the OECD Model Convention.

36 There are 42 double tax treaties currently applicable between Latvia and other countries. Majority of them are concluded with other EU Member States.

The CITL provides that credit institutions are exempted from the thin capitalization rules. It follows from the Credit Institutions Law[37] that this the exemption applies both to non-residents and residents operating in Latvia.

Apparently, because of the exemption, the CITL seems to imply that a bank provides loans to non-related parties only and thus never lends excessive amounts. However, the CITL does not take into account that, theoretically, a number of transactions can be carried out between a credit institution and its subsidiary or between a credit institution and its permanent establishment (e.g. branch). Therefore, two major questions might arise from this treatment. First, whether any amount of payment transferred between a bank and its subsidiary/branch can be considered as interest for tax purposes? Second, if not, what is the threshold above which payments must be reclassified? Clear answers to these questions cannot be found in the CITL.

In addition, it is not clear whether the deduction of interest should be allowed when branch profits are calculated, because, theoretically, a company can never make a loan to itself and, therefore, can never receive an interest payment from itself.[38] This question is of particular importance in the light of on-going discussions encouraged by the OECD on the appropriate method of profit attribution to permanent establishments in the banking sector.[39] In brief, these OECD initiatives suggest using the "functionally separate entity approach" for transactions between banks and their permanent establishments. This means that the profits to be attributed to a permanent establishment would be the profits that the permanent establishment would have earned at arm's length as if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle under Article 7(2) of the OECD Model Convention[40].

Should also Latvian banks apply the arm's length approach to determine the amount of allowable interest? Probably, it can be said that, at the moment, the issue does not emerge in the Eastern European countries like Latvia.[41]

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37 Credit Institutions Law of 5 October 1995, as amended (publ in the Official Gazette "Latvijas Vestnesis" No 163, dated 24 October1995)

38 Shelton, N. (2004), p. 337

39 The OECD Report (2006), part II

40 The OECD Report (2006), paragraph 10

41 KPMG Survey regarding methods currently used by countries to attribute profits to permanent establishments of banks concluded that in the Eastern European countries the issue is only just beginning to emerge as banking branches become more common (see KPMG (2005), p. 648)

Maybe, there is some reason to favour loan transactions between credit institutions and their subsidiaries, allowing them to escape from the thin capitalization rules. If there is a reason, it has to be made clear. One can contest here that credit institutions are not favoured, because they should observe the arm's length principle. However, a further question arises as to whether other companies can apply the arm's length approach for their loans as well.

In addition, there are no provisions indicating the further steps to be taken after a credit institution calculates the excessive interest according to the arm's length method, i.e. should the excessive interest be disallowed and what adjustments have to be made in this regard.

b) Thin capitalization rules amended where it was not necessary

Another problem can be found in legislation regulating the application of thin capitalization rules to credit institutions. This is, however, not a substantial issue but rather an example illustrating the problems which may arise in the adoption process of legislation.

Latvia's thin capitalization rules were amended in 2006. Amendments were drafted to ensure the compliance of the CITL with the EC Treaty. However, the author of this paper considers that these amendments were not necessary for the following reasons.

Between 1 May 2004 and 1 January 2005, it was believed that the CITL provided that thin capitalization rules applied to interest returned to an EU Member State credit institution, whereas they did not apply if interest was returned to resident credit institutions. It has been argued[42] that, most probably, the freedoms of the EC Treaty were violated during that period.

However, in the author's opinion, the definition of "a credit institution" in force at that time has to be read again before stating that firmly. As a result of a more careful reading of the rules, it is obvious that there was no violation of EC law since the term "credit institution" included both Latvian and EU/EEA entities. Thus, in fact, no amendments regarding credit institutions were necessary. Now, after the amendments, the law explicitly mentions EU credit institutions. Moreover, the current provisions might mislead a taxpayer, because EEA credit institutions are not mentioned. Therefore, in my opinion, the respective amendments of the CITL were not necessary and have in fact served to confuse taxpayers.

42 Kronbergs, Z.G. (2005), p. 409

1.2.2 Issues arising from the application of Latvian thin capitalization provisions to partnerships

Thin capitalization rules have to be clearer on whether they apply to partnerships. As it can be seen from the provisions of the CITL, particular persons are excluded from the list of those subject to the thin capitalization provisions, thus allowing them to maintain particular types of financing structures where thin capitalization rules can be completely avoided.

The definition of "a taxpayer" excludes partnerships. Most likely, partnerships are treated as transparent for corporate income tax purposes, as the profits are taxed in the hands of the partners and not the partnership (CITL, Article 2(2)), however law does not explicitly explain its position in respect of this issue.

The CITL has to be taken into account when a partnership's tax return is prepared and submitted to Latvian tax authorities. Therefore, thin capitalization rules need to be more explicit regarding their applicability to partnerships. In particular, further guidance is necessary to confirm whether thin capitalization rules have to be taken into account when a corporate income tax return of a partnership is prepared.

1.3 Suggestions for amendments to Latvian thin capitalization rules with respect to persons

Previous parts identified a number of problems in Latvian thin capitalization rules when they are applied to particular persons. First, Latvian thin capitalization rules do not comply with the EC Treaty and the EEA Agreement. Second, they might be considered as incompatible with particular double tax treaty provisions. Third, the rules are not clear on how they should be applied to particular transactions of credit institutions. Finally, the rules should be more explicit on whether they apply to partnerships.

Further discussion outlines some suggested changes to these rules.

1.3.1 Amendments to comply with the EC Treaty/EEA Agreement

Latvian thin capitalization rules should be amended to comply with the EC Treaty and the EEA Agreement. The ECJ *Lankhorst-Hohorst* case confirms that the tax treatment of interest should be the same irrespective of which EU Member State is the country of residence of the recipient.

The question is whether thin capitalization provisions applying to both domestic and cross border interest payments would be an acceptable solution to the problem? The experience of other EU Member States provides some guidance in this regard.

Several EU Member States had to amend their thin capitalization rules after the ECJ's decision in the *Lankhorst-Hohorst* case. Before that case was decided, many EU Member States applied thin capitalization rules only when interest was transferred across borders.

After the ECJ's decision some EU Member States abolished thin capitalization provisions. In turn, several other countries initiated the application of thin capitalization provisions to all interest payments irrespective of the recipient country. However, the approach of applying thin capitalization rules to both domestic and cross-border interest payments has been criticized widely. In 2006, the Advocate General Geelhoed in *Thin Cap GLO* opinion said that he finds this

> *"(..) extremely regrettable that the lack of clarity as to the scope of the Article 43 EC justification on abuse grounds has lead to a situation where EU Member States, unclear of the extent to which they may enact prima facie "discriminatory" anti-abuse laws, have felt obliged to "play safe" by extending the scope of their rules to purely domestic situations where no possible risk of abuse exists*."

He further admits that

> "*such an extension of legislation to situations falling wholly out with its rationale, for purely formalistic ends and causing considerable extra administrative burden for domestic companies and tax authorities, is quite pointless and indeed counterproductive for economic efficiency. As such, it is anathema to the internal market.*"[43]

It must be noted, however, that, in the *Thin Cap GLO* case, the ECJ did not consider the above point made by AG Geelhoed and therefore did not provide any further clarity as to whether the extension of national anti-abuse rules to purely domestic situations can be considered as being in line with the spirit of the EC Treaty.

To conclude, the thin capitalization rules can be extended to domestic payments. However this would be a rather formal solution of incompatibility problem and might initiate other problems. The author of this paper suggests to avoid formal solutions and reconsider thin capitalization provisions taking into account their aim to prevent the abuse of tax law.

1.3.2 Amendments to comply with double tax treaties

The analysis above concluded that a non-discrimination clause of a double tax treaty overrides thin capitalization provisions, should they be in a conflict. There are two solutions to avoid such conflicts. First, thin capitalization rules can be changed so as

43 AG Geelhoed, *Thin Cap GLO*, paragraph 68

to apply to both the interest distributed to a third country and the interest distributed domestically. Alternatively, the non-discrimination provisions of a double tax treaty can be amended to include the conflicts clause which allows tax treatment of interest paid across borders to be different from the tax treatment of interest paid to another resident of the same country. Before any of the solutions is adopted, there has to be research into whether a conflict exists between Latvian thin capitalization provisions and the non-discrimination clauses of Latvian double tax treaties.

1.3.3 Clearer provisions with respect to the credit institutions and partnerships

As mentioned above, Latvian thin capitalization rules are not precise with regard to credit institutions and partnerships. First, the provisions do not state explicitly whether credit institutions should apply the arm's length approach in the cases when interest is paid between related parties. In addition, the provisions have to define whether all EU/EEA credit institutions are excluded from the scope of the rules or only those of the EU. Second, it is not clear from the CITL whether thin capitalization rules apply to partnerships at all.

These insufficiencies might lead to the misapplication of the rules. Moreover, uncertainties could become the basis for tax assessments or basis for appeals and disputes between tax authorities and taxpayers. Therefore, it would be advisable to supplement thin capitalization provisions with additional explanations.

2. Problem questions of excessive interest calculation methods

This part of the paper analyses the methods of Latvian thin capitalization rules. These methods are used to determine the amount of disallowable interest. First, the debt to equity ratio method and the formula method is discussed. Then, the analysis outlines problems with two other methods – the substance over form method and the arm's length method (as noted above, application of the latter method is not explicitly allowed by the law, however it can still be disputed whether this method is applicable).

These methods affect the amount of the deductible interest and thus, the amount of corporate income tax payable. It is important, therefore, to determine in the following analysis whether they lead to a fair result.

2.1 Debt to equity ratio method and formula method

This section discusses the debt to equity ratio method and formula method. Both the debt to equity ratio method and the formula method are two basic approaches used to calculate the disallowable interest according to Latvian thin capitalization rules. Both methods were implemented along with the adoption of the rules in 2003.

2.1.1 Debt to equity ratio method

Latvia adopted the debt to equity ratio method because it was used in the majority of developed countries.[44] However, despite its wide usage the method has been subject to criticism.

The significant argument for the debt to equity ratio method is that it requires a rather technical approach to make the necessary calculations, thus minimizing administrative expenses.

Nevertheless, there are several arguments against the method leading to the conclusion that the debt to equity ratio method can be unfair when used for tax calculations.

First, there is no overall acceptable standard of what can be considered as a "high" debt if compared to equity. A long time before Latvian thin capitalization rules were adopted, the OECD pointed out that it is not clear what relationship between debt and equity should be taken as the basis in deciding whether a company's debt is high in relation to its equity capital[45].

Another reason is that the debt to equity ratio can differ per industry[46]. It is assumed that average ratios found in a particular industry or country may give some indication of the point around which such ratios might be expected to cluster (for example, for the United Kingdom finance businesses a gearing of between 10:1 and 20:1 can be accepted[47]); however these ratios should not be generalized and applied to all industries equally.

Third, an objective ratio for one company might not be the same for another even within the same industry, because there can be other criteria (such as obstacles or difficulties peculiar only to several firms within the industry) which could affect the granting of a loan.

It is suggested that the debt to equity ratio method should not be the only method used by a country to calculate the excessive interest. Thin capitalization rules can become more flexible if taxpayers can choose between several alternative methods. Further discussion on alternatives is included in the part 2.1.3.

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44 Ministry of Finance, Republic of Latvia (2003), p. 21.

45 The OECD Report (1986), paragraph 12

46 Jamieson, R., Rayney, P. (1995), p. 61

47 Godman, R. (1999), p. 22

2.1.2 Formula method

This method may be used as an alternative to the debt to equity ratio method. However, the CITL stipulates that the method leading to a larger taxable income has to be applied. Thus, the formula method will be used as an alternative to the debt to equity ratio only when it will generate larger taxable income.

The formula method has some features of both the debt to equity ratio method and the arm's length approach. Namely, it uses a particular method to determine the level of excessive interest and applies to it a percentage rate which is based on the average short-term interest rates applied by banks.

a) Arguments supporting the method

It can be argued that this approach leads to a fairer result than the debt to equity ratio method. This is because the interest rate is compared to the average interest rate provided by banks, which can be regarded as a neutral comparable. Thus, the amount of deductible interest is determined according to prices usually offered in the market.

Put simply, the formula approach links the interest rate for thin capitalization purposes to the average prices in the market. In contrast, the debt to equity ratio method is tied to the company's ability to repay the loan without taking into account other obstacles or market specifics which might support the high interest rate used by the company.

b) Arguments against the method

There are several arguments against the formula approach. Similar to the debt to equity ratio approach, numbers used in the formula approach might not lead to objective results. Neither Article 6.4 of the CITL, nor the documents supporting the adoption of this Article explain the economic or any other rationale for applying the number "1.2" in the formula (to determine the amount of deductible interest the average short term interest rate is multiplied by 1.2). Similarly as with the debt to equity ratio of 4:1, the question of why this particular number is used remains unanswered.

Moreover, the objectivity of the average short-term interest rate might be disputed. The question to be asked here is why this particular interest rate should be used as basis for deductible interest calculations. There are several reasons why the average short-term interest rate of banks might not be the most objective comparable.
First, the average short-term interest rate can be affected by the high credit worthiness of banks and their subsequent ability to receive loans for a price lower than a that available to any other company.

Further, risk factors can affect the amount of average short-term interest rate of banks. Usually, a bank will grant a loan if appropriate collateral is provided/loan is secured. In such a case the risk that loan will not be recovered is minor and, therefore, reduces the amount of interest rate. On the contrary, this might not always be the case where one company grants a loan to another, for example, where a loan is granted to a special purpose vehicle for the acquisition of an immovable property and that acquisition is treated as involving a great risk. It may be that no collateral can be given to secure this loan for purely commercial reasons. As a result, the lender should be entitled to receive a higher interest rate that takes account of the increased risks involved.

There are many other examples where the interest rate can be higher than the average short-term interest rate applied by a bank, taking into account the particular circumstances of the transaction.

Finally, the comparable average short-term interest rate is applied as a comparative for all loans, irrespective of whether these are short or long-term.[48] Usually, a short-term interest rate will be higher than a long-term interest rate. CITL provisions do not take this into account.

2.1.3 Latvian thin capitalization methods should be more flexible

a) Thin capitalization rules supplemented by arm's length alternative

The practice of other EU Member States, various recommendations and opinions suggest that a debt to equity ratio method (or any other fixed single criterion, like formula) should not be the only method to decide whether a company is thinly capitalized for tax purposes. As it will be discussed further below, countries have been advised to implement alternatives which would allow taking other circumstances of the transaction into account.

The OECD suggests that the debt to equity ratio should be used only as a "safe haven", leaving the relevant company the option of showing that the actual ratio is an arm's length ratio.[49]

Lately, the Advocate General Geelhoed opined that the thin capitalization rules have to be proportionate anti-abuse measures where taxpayers are clear what is required of them. He said that

> *"(..) companies have the right to structure their affairs as they wish and finance their subsidiaries either by debt or equity means. However, this*

48 CITL does not distinguish between short-term and long-term loans.

49 The OECD Report (1986), paragraph 79

> *possibility should reach its limit when the company's choice amounts to abuse of law*." [50]

Many countries have followed the suggestions of the OECD. The United Kingdom does not have statutory ratios[51] because they are insufficient in themselves to determine what would have happened at arm's length.[52] The United Kingdom applies arm's length approach since 2004.[53] Similarly, in Denmark a company can avoid the interest-deduction limitation if it is able to demonstrate that a similar loan relationship could exist between unrelated parties.[54]

The Advocate General (AG) Geelhoed agreed that the United Kingdom's arm's length approach serves as a valid starting point to assess whether the transaction is abusive or not, if the state sets reasonable criteria against which the compliance is assessed. He expressed his support for precisely defined arm's length criteria, whereas did not favour the use of a single fixed criterion to be applied in all cases – such as a fixed debt-equity ratio, which does not allow other circumstances to be taken into account.[55]

The above opinions and experiences confirm that Latvian thin capitalization rules should be more flexible and provide for alternatives when determining the amount of the excessive interest. An alternative, for example, could be the arm's length method according to which a taxpayer is, under certain circumstances, allowed to deduct the interest in excess of the amount determined according to statutory ratios. One of such circumstance could be the existence of the proof that the transaction is driven by commercial reasons.

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50 AG Geelhoed, *Thin Cap GLO*, paragraph 66

51 However, in practice tax authorities of the United Kingdom often seek to impose the 1:1 debt to equity ratio and 3:1 interest to income cover ratio in relation to intra-group funding or at least are willing to use such ratio as a starting point in negotiations; See: Nias, P.M.W., Purcell, N. (2005), p.438; Lee, N. (2006), p. 1003

52 IR Tax Bulletin, Issue 17 (1995)

53 It has been argued that the arm's length approach is not the most effective solution to determine the amount of allowable interest, because sometimes it might be extremely difficult to find a comparable. See: Hansen, A.O., Munch D.A. (2003), p. 1341; Oldknow, D., Donnelly, M. (2004), p.3; Van der Breggen, M.E.P. (2006), p. 296

54 The regime of Denmark is currently discussed and might be subject to changes in the future.

55 AG Geelhoed, *Thin Cap GLO*, paragraph 66

b) Thin capitalization rules supplemented by "de minimis" test

This is another suggestion as to how the current thin capitalization rules could be improved. Thin capitalization rules of some other countries have *de minimis* test.[56] This test allows the exclusion of a minimum level of interest from thin capitalization rules. This approach helps to reduce unnecessary administrative costs both for companies and tax authorities because the calculations according to thin capitalization rules should not be made if insignificant amounts are involved.

c) Thin capitalization rules require mutual co-operation with other countries

Countries having thin capitalization legislation have been advised to maintain bilateral arrangements with other states to avoid double taxation of reclassified interest payments. Double taxation might occur when, for example, interest for a loan granted by a non-resident to Latvian resident is treated as being excessive based on the debt to equity ratio. However, at the same time the country of a recipient might consider that amount as not being excessive. Thus, a part of interest might be taxed twice due to the different classification in both countries.

As suggested by the International Fiscal Association, the use of safe havens certainly seems to require a bilateral arrangement with the foreign tax authority in order to avoid conflict between two diverging transfer prices.[57] Similarly, the AG Geelhoed opined that the Member State applying thin capitalization rules must ensure via the double tax treaty that the requalification of the transaction within its tax jurisdiction is mirrored by a counterpart requalification in the parent company's Member State. He thinks this contributes to the rules in a way that they become proportionate to their aim.[58]

2.2 Substance over form approach and arm's length method

This part briefly outlines the main problems concerning the application of the arm's length approach and the substance over form approach. The author of this paper believes that the rules have to be elaborated in more detail and, more specifically, have to clarify the conditions for their application to loan relationships.

2.2.1 Arm's length method

Latvian thin capitalization rules do not explicitly stipulate whether a company is allowed to opt between the arm's length method and the statutory debt to equity

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56 The *de minimis* test exists in the United Kingdom and has been considered in the Netherlands. See, for example: Sunderman, M. (2004), p. 37

57 International Fiscal Association (1992), p.33

58 AG Geelhoed, *Thin Cap GLO*, paragraph 69

ratio/formula method when determining the amount of excessive interest. The arm's length method is not even mentioned as a possible approach to calculate the deductible interest. Whereas, credit institutions have to apply this method even though they are exempted from thin capitalization rules. This situation illustrates the need for clearer rules.

2.2.2 Substance over form approach

The substance over form approach is a new concept in Latvian thin capitalization rules. Probably, their recent adoption (the rules are applicable since 1 January 2007) is the only reason there is no further guidance on the criteria to be taken into account when deciding on the substance of the transaction. However, since the tax treatment is different depending on whether the transaction is qualified, on the basis of this approach, as a loan or equity investment, it would be very important to elaborate the approach and provide tax authorities and taxpayers with further guidance.

In addition, the relationship between these two methods (the arm's length method and substance over form doctrine) and the regular thin capitalization methods (the debt to equity ratio method and the formula method) should be established. This might include clarification as to whether one method has priority over the other and in what circumstances each method applies.

3. Other problem questions arising from thin capitalization rules

This part discusses several other specific problems which may arise when Latvian thin capitalization rules are applied in practice.

First, the distinction between debt and equity investment is discussed. Latvian thin capitalization rules do not provide criteria to distinguish between the two types of financing, while the distinction is important because it affects whether the payment in return is classified as interest or dividends. The paper identifies problems which might arise due to the lack of such criteria and mentions the criteria adopted by the United Kingdom and the OECD (sub-part 3.1).

Second, a country's thin capitalization rules may contain a number of supplemental measures that would prevent tax avoidance. The paper discusses several examples of such measures in other countries and identifies whether Latvian thin capitalization rules would need any changes in this regard (sub-part 3.2).

3.1 The distinction between debt and equity investment

Several countries have implemented guidelines to identify differences between debt and equity investment and, accordingly, interest and dividends. As mentioned earlier, this distinction might be of particular importance in Latvia when the substance over form doctrine is applied.

This sub-part, first, mentions some examples where debt cannot be clearly separated from equity investment. Further, the Latvian definition of interest is discussed and compared with the definition in the United Kingdom. The final part identifies the criteria to distinguish between debt and equity investment and, accordingly, interest and dividends.

3.1.1 The borderline between debt and equity investment might be difficult to determine

As said before, a company might replace an equity investment with a loan to finance another company (most likely, a subsidiary). The decision in favour of debt financing can be driven either by commercial or tax reasons.

Irrespective of whether the purpose of the loan financing is tax abuse or tax planning, it might be difficult to determine whether the substance of this transaction is a loan or equity investment, when it has the characteristics of both. For example, creditors may, at some stage, be able to convert their debt into a participation in the equity of a company, or the interest may be linked to the profits of the company.[59] Another example might be a transaction based on a contract which has some, but not all, of the characteristics of debt. For example, a contract may give voting rights, but a fixed rate of return; or a fixed rate of return plus some proportion of residual income; or may provide for a fixed return but not provide for the prior claim to income.[60]

Failure to specify the criteria for distinguishing between debt and equity investment might foster broad interpretation of substance over form doctrine. To avoid this problem, the thin capitalisation rules of some countries have a clear "interest" definition and provide additional criteria to assist in deciding whether the payment is a loan or an equity investment.

However, there is no single definition of "interest" in Latvian law. Instead, there are several definitions including those used by double tax treaties. In addition, Latvian thin capitalization rules do not provide criteria to distinguish between debt and equity investment. These issues are discussed in more detail in the following sub-parts.

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59 The OECD Report (1986), paragraph 11

60 Devereux, M. (2006), p.10

3.1.2 Meaning of "interest" in Latvia

Analysis of Latvian thin capitalization provisions indicates that disputes might arise as to whether a particular payment can be treated as "interest" for thin capitalization purposes. This is because different laws exploit various phrases that refer to "interest", but none of them is explicitly linked to the thin capitalization provisions. In particular, Latvian legislation refers to "interest", "interest payments" and "interest income". A general definition of "interest" is given in the Civil Law, adopted in 1937. The law provides that "interest" is

(a) the compensation to be given for granting the use of, or for late return of a sum of money or other fungible property;

(b) proportionate to the amount and the duration of the use;

(c) subject to the condition that a principal or capital debt is outstanding.

Generally, interest should consist of the same type of property as the principal debt, however, where the money is lent, the parties are allowed to agree that creditor may use some property of a debtor or receive some other performance from the debtor (Civil Law, Articles 1754 and 1755). It is not said whether this definition must be used for tax purposes.

In turn, the CITL defines "interest income". This is income from any debt liabilities, securities issued by the state, bonds, including income from premiums and prizes along with these securities and bonds (CITL, Article 1 (7)). Probably, it can be said that "interest income" for the recipient party equals to what the other party has paid for a loan. At the same time, this definition is very broad and does not give more precise criteria which might be helpful in determining if the substance of the payment is, actually, dividends and not interest.

Moreover, Latvian thin capitalization provisions use neither the first, nor the second wording mentioned above. Instead, they use "interest payments". In turn, this wording has been criticized by another author as being inconsistent with Latvian Generally Accepted Accounting Principles, which refer to "interest payable" (accrued as well as paid).[61]

As it can be seen from the above, Latvian law is not consistent with respect to the term "interest" and its meaning for the purposes of thin capitalization rules. In addition, none of the court cases found by the author of this paper refer to the interest in the context of thin capitalization rules or distinguishes between interest and dividends in the context of the thin capitalization legislation. This can probably

61 Kronbergs, Z.G. (2005), p.408

be explained by the rather recent adoption of the thin capitalization rules in Latvia; thus no disputes have reached courts yet.

Lack of precise definitions or guidelines might lead to a broad interpretation according to the substance over form doctrine, as well as might increase the tax avoidance risks.

Further analysis focuses on the experience of the United Kingdom regarding the boundaries of interest used for thin capitalization purposes. It also provides a summary of the OECD criteria for distinguishing between debt and equity investment. The aim of the following analysis is to illustrate how the problems and risks Latvia might face are resolved elsewhere.

3.1.3 Meaning of "interest" in the United Kingdom

There is no statutory definition of "interest" in the United Kingdom. Instead, the case law and statutes of the United Kingdom provide a set of criteria which help to classify a particular payment as interest.

The general criteria to determine interest is, in broad terms, similar to those of Latvian Civil Law, namely - there has to be a particular sum of money lent by a creditor to a debtor and the payment has to be made with reference to that particular sum of money[62] and recompense for being deprived of the use of his money[63] or loss suffered due to deprived rights of using the money.[64] Similarly, another case defines interest as the creditor's share of a profit which the borrower or the debtor is presumed to make from the use of the money.[65] The sum of money must be due to the person entitled to the payment.[66] According to the United Kingdom's case law, interest can be a variable sum contingently payable, which includes an amount calculated and described as interest.[67]

In order to decide whether thin capitalization rules should be applied, interest needs to be distinguished from dividends. To find that out, the OECD suggests establishing whether the finance granted was a debt or rather an equity investment.

62 *Bennett v Ogston* [1930] 15 TC 374

63 *Schulze v Bensted,* also known as *Lees Trustees v Inland Revenue Commissioners* [1915] 2 S.L.T. p. 384

64 *Riches Appellant v. Westminster Bank Limited Respondents* [1945], Ch 381

65 *Schulze v. Bensted* [1915] 1915 2 S.L.T. 382-386

66 *Euro Hotel (Belgravia) Ltd, Re* [1975] S.T.C. 682

67 *Chevron Petroleum (UK) Ltd v BP Petroleum Development Ltd* [1981], S.T.C. 689

3.1.4 Debt or equity investment?

If a company grants a loan to another, the payment in return is interest. In turn, if a company makes an equity investment, it will receive dividends in return. Sometimes it might be difficult to determine whether the substance of the transaction is debt or equity investment and, accordingly, whether the return is interest or dividends. Therefore, the OECD recommendations and United Kingdom case law suggest certain criteria to distinguish between the both.[68]

A payment might be an equity investment rather than a loan if:

(a) the contribution would have been a contribution to equity than a loan were the parties not connected or related;

(b) the contribution of a loan is proportional to existing shareholdings;

(c) a creditor grants a loan subject to the condition that he holds borrower's shares;

(d) the loan is designed to improve the financial situation arising from heavy losses;

(e) the loan is convertible and can be turned into a share of company's equity;

(f) there are no fixed provisions for repayment of the loan by a definite date;

(g) it was designed to finance long term needs of the borrower;

(h) the debt element of the company's financing is already abnormally high in relation to the equity element.

In turn, a payment might be dividends rather than interest:

(a) if the payment is made by reference to the profits of a business.[69] It follows from *AW Walker & Co v IRC*, that it might be a sum paid in a certain proportion to the borrower's profits and not paid if the business is not profitable;

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68 The OECD Report (1986), paragraphs 75 and 76; case law of the United Kingdom (see the references in the text); ICTA, s 209 (2) (e); The OECD criteria to distinguish between the debt and equity investment are also mentioned by several authors. See, for example, Collins, M.H. (1996), p. 53

69 *AW Walker & Co v IRC* [1920] 12 TC 297, p.302

(b) irrespective of the title of the payment. As decided by the court in the *Bond v Barrow Haematite Steel Company* more than a century ago, "interest" is not an apt word to express the return to which a shareholder is entitled in respect of shares paid up in due course and not by way of advance;[70]

(f) if the interest or the return of a loan is subordinated to the rights of other creditors;

(g) interest exceeds a reasonable commercial return on the money lent.[71]

However, the OECD has noted that the presence of any one of such factors by itself would not necessarily be conclusive evidence, though it might be an important indication of hidden equity capitalization, but the presence of several such factors would be more indicative and clearly the indications would be stronger the more such factors were present.[72] Therefore, the list itself should not be treated as exhaustive and individual judgement on case-by-case basis remains to be very important.

3.1.5 Lessons to learn

Latvia can learn from the above suggestions and experiences. First, the above examples illustrate the criteria that can be used in order to classify funds granted by one company to another as an equity investment rather than loan, and, accordingly – the return payment as dividends rather than interest. Latvia could use similar criteria when the substance over form doctrine is applied.

Second, it can be seen from the analysis that the definition of "interest" does not play a major role when establishing whether the payment is dividends rather than interest. However, it does not mean that the definition of "interest" can be misleading. Currently, several definitions which might be used in the context of Latvian thin capitalization rules partially overlap. A single definition of "interest" for thin capitalization purposes would make the rules clearer.

3.2 Thin capitalization rules as anti-avoidance measures

A country's thin capitalization rules might include a number of supplemental measures that would prevent tax avoidance. This part of the paper discusses the measures applied by other countries and identifies whether Latvian thin capitalization rules would need any changes in this regard.

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70 *Bond v Barrow Haematite Steel Company* [1902] 1Ch 353, p.363

71 The OECD Report (1986), paragraph 75

72 The OECD Report (1986), paragraph 75

3.2.1. Applicability of thin capitalization rules when a loan is granted by a third party

a) Experience of other countries

Granting a loan through a third party was a topical issue in the United Kingdom more than ten years ago because many companies used this route to escape thin capitalization provisions at all.

Currently, the United Kingdom distinguishes between the situation where a related party provides a guarantee to a bank which then, on the strength of this, makes a loan or an additional part of a loan available to a borrower, and the situation where the guarantee solely reduces the rate of interest being charged and the United Kingdom borrower is not thinly capitalized.[73] In broad terms, this means that if the loan exceeds what the United Kingdom subsidiary could have borrowed on the strength of its own balance sheet, thin capitalization rules would be applicable. However, if the effect of the guarantee can be justified by commercial reasons (for example, reduced rate of interest), thin capitalization rules would not come into play.

A similar approach was also considered in Germany.[74]

In general, the use of intermediaries (like credit institutions) is a popular way to structure financing of companies world-wide. This can be observed from many cases in other countries[75] which discuss the role of the intermediary, the substance of the transaction and, thus, the applicable tax regime. However, this is also a very complicated task for tax authorities to find out the substantive meaning of the transaction.

b) Latvia - unlimited interest deduction when a loan granted by a credit institution?

Currently, Latvian thin capitalization rules do not provide guidance on whether substance over form doctrine should be applied when interest is paid to banks. It is clear, however, that companies might be willing to escape thin capitalization rules via this route, namely, to receive a third party guaranteed loan from a credit institution. Latvian thin capitalization rules would need to be supplemented by additional anti-avoidance provisions or, alternatively, guidelines on how the

73 HM Treasury, Explanatory note on Finance (No.2) Bill 1998, cl 106 and Sch 16(para44); and IR Tax Bulletin , October 1998, p.581

74 Penndorf, H., Sinewe, P. (2006), p. 1001

75 See, for example: *Bank of Scotland* (France), CE 29 December 2006, No. 283314; *Market Maker's Case* (the Netherlands), BNB 1994/217c

substance over form doctrine should be applied when a credit institution grants the guaranteed loan.

On the other hand, it might be difficult to prove that the financing granted by a credit institution is, in fact, an equity investment rather than a debt. This might be complicated because of several parties (a credit institution, a guarantor and a borrower) involved in series of transactions. Moreover, banks might not be willing to provide information about their clients; and transactions might be structured in a way to make it difficult to find out that the particular transaction is, actually, an equity investment by a foreign company rather than a loan granted by a bank. In addition, the evidence collection might be rather expensive because close co-operation between tax authorities of Latvia and other countries might be needed.
Latvian thin capitalization provisions should entail more detailed anti-avoidance measures that would prevent the possibilities to escape the rules by granting an excessive loan via credit institution. These provisions could be an alternative to the substance over form doctrine and could, for example, disallow the proportion of the excessive interest paid to a credit institution for a loan this company could not have borrowed on the strength of its own balance sheet. In addition, the law might provide that a company is allowed to supply tax authorities with the evidence confirming the need for that particular amount of interest for purely commercial reasons thereby escaping the application of thin capitalization rules.

3.2.2 Other issues

The anti-abuse role of Latvian thin capitalization rules might be discussed further in the light of the experience of other countries. As a result, additional possibilities to enhance Latvian rules might be identified. The following part of the paper briefly outlines several of these issues.

a) Scope of the applicability of thin capitalization rules with respect to types of transactions

Latvian thin capitalization provisions limit their applicability to certain types of legal relationships. However the scope of transactions caught by the rules is not clear. Namely, the law provides that the provisions apply to all types of debt liabilities, as well as to finance lease and recourse factoring.[76] This provision puts a burden of proof on taxpayers as they have to interpret and decide whether the liabilities arising from their agreements fall within the broad scope of the term “all types of debt liabilities” and thus, are subject to the thin capitalization provisions. This diminishes the level of legal certainty – persons may not be sure whether tax authorities will interpret the broad scope of applicability rules in the same way.

76 CITL Implementing Provisions, paragraph 72

In general, there is no clear-cut border distinguishing between the transactions creating a "debt liability" and transactions being "equity investments". Broadly speaking, even an equity investment can be regarded as creating a "debt liability", because it obliges a borrower to give something in return.

Moreover, there are many transactions having characteristics of both the debt and equity. In addition, a situation might arise where legislations of two countries classify one and the same transaction differently and, as a result, apply different tax treatments. For example, Latvian legislation does not recognize such transactions as bonds or other more complex types of financial transactions. The parties will, therefore, have to make their own judgement on the basis of the broad term "debt liability" in order to determine whether thin capitalization rules apply. Whereas, it may be that in other jurisdictions bonds are explicitly stated to fall into a specific (and probably different than in Latvia) category of agreements.

b) Loans provided by an employer to employee

It is suggested that abusive practices might incur due to lack of regulation in regard to loans provided by an employer to employee or loans made to shareholders and their associates.[77] Latvian thin capitalization rules do not focus on consequences arising from such transactions.

The above list of problem questions is not exhaustive. There might be other issues to consider in the light of the anti-abuse role of thin capitalization provisions. These could be of either of substantive or administrative character. Substantive issues would involve the interpretation of thin capitalization provisions. For example, what are the boundaries of the substance over form doctrine. Administrative issues would require focusing on procedural issues, for example, the exchange of information between countries to avoid double taxation when interest is transferred from Latvia to another country. Several problem questions might arise along from any amendments of the thin capitalization rules, for example, when the rules are amended to allow determining the amount of excessive interest by applying the arm's length as an alternative to the debt to equity ratio method and formula method. In addition to substantive amendments, such changes might require the implementation of advance pricing agreement procedures.

V Conclusions

Following the practice of other EU Member States, Latvia implemented thin capitalization rules in 2003. Since then, thin capitalization rules of many states have been amended to ensure their compatibility with the EC Treaty and recommendations of the OECD. This paper suggests amending Latvian thin

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77 European Commission, CCCTB Working Group Working Paper (2006), paragraph 24

capitalization rules as some areas of them contradict the latest developments in the EC tax and international tax areas, as well as conflicting with provisions of other domestic laws.

The paper concludes that Latvia's current thin capitalization provisions discriminate against companies which receive loans from a non-resident. The discriminatory treatment arises from the provision that the rules do not apply when interest is paid to a Latvian resident (whereas the rules apply when interest is paid to non-residents). Discriminatory treatment is prohibited by the EC Treaty and the non-discrimination article of double tax treaties drafted in accordance with Article 24 of the OECD Model Convention. Therefore, the paper suggests amending the rules to prevent such discriminatory treatment.

Also, the paper suggests that Latvian thin capitalization provisions should be supplemented by the arm's length method since the current methods, namely, the debt to equity ratio method and the formula method, are rather static and do not allow taxpayers to supply additional information that justifies the necessity of deducting a certain amount of excessive interest for commercial reasons. In addition, the circumstances when the substance over form doctrine can be applied would need to be elaborated to clarify when a particular payment can be considered as interest. Further, the rules should be made clearer as regards the method which prevails, should either of the two static methods conflict with the substance over form doctrine.

The paper also identifies several problems arising from the imprecise wording or lack of definitions in Latvian thin capitalization provisions. Namely, these shortcomings give rise to uncertainty regarding the interpretation of thin capitalization rules. Moreover, they create the room for tax avoidance. Since the main purpose of thin capitalization rules is to serve as sound tax anti-avoidance measures, they should be of sufficient clarity as to avoid any misinterpretation. The paper proposes to clarify the wording of some provisions, for example, by explicitly stipulating whether certain sophisticated financial transactions are caught by the rules and what is the tax treatment of excessive interest paid between related credit institutions.

To conclude, the analysis of the paper shows that Latvian thin capitalization provisions should be amended. This paper mentions some problematic areas of these provisions and outlines a number of suggestions as to how the rules might be improved.