

27 May 2016

Progress report of FICIL's recommendations on Tax Policy and Tax Administration

1. Assessment of the current situation and retrospect to the progress achieved

Latvia has been ranked as 22nd in the *Doing Business 2016* report¹, and one of the most significant reasons for the lowest ranking among the Baltic States in the aforementioned report is “*Paying taxes*”² section. The OECD³ in its working papers on the situation in Latvia⁴ admits that the shadow economy is relatively large and that firms are more dissatisfied with the tax system and public administration than in our neighbouring countries, as well as poor tax compliance and the efficiency of tax collection must be significantly improved. The labour income tax burden is relatively high by international standards as well.⁵ Moreover, the World Economic Forum's Global Competitiveness Report ranks Latvia's efficiency of legal framework in settling disputes as 117th out of 148 countries.⁶ It takes many years to resolve tax disputes; the timeframe for dispute resolution is inefficient and embarrassing for foreign *bona fide* taxpayers as well.

In order to promote a competitive business environment in Latvia and to increase Latvia's international attractiveness in the perspective of a predictable long term tax policy, and to achieve growth levels that would ensure convergence of Latvia's economy with the OECD economies in a foreseeable future, FICIL in the previous 10 years has provided recommendations for improving the macroeconomic and tax policy in Latvia.

All the recommendations made by FICIL have now been summarized and analysed in respect of what has been implemented, *e.g.*, loss carry forward for an indefinite period of time, development of capital gains tax and stock options, introduction of a special VAT reverse-charge regime for construction works and others, partially implemented and unimplemented (please see the diagram below). The latter were prioritized and further updated with the purpose of attracting the government's attention to them to follow up from the past and future outlook perspectives to continue to improve tax policy and tax administration in Latvia.

¹ World Bank. 2016. *Doing Business 2016: Measuring Regulatory Quality and Efficiency*. Washington, DC: World Bank. DOI: 10.1596/978-1-4648-0667-4. License: Creative Commons Attribution CC BY 3.0 IGO – p.5, p.175.

² *Ib.*, a quotation: “*Latvia made paying taxes more complicated for companies by eliminating the possibility of deducting bad debt provisions. On the other hand, Latvia reduced the rate for social security contributions paid by employers.*”

³ The Organisation for Economic Co-operation and Development (OECD). Please see: <http://www.oecd.org/>.

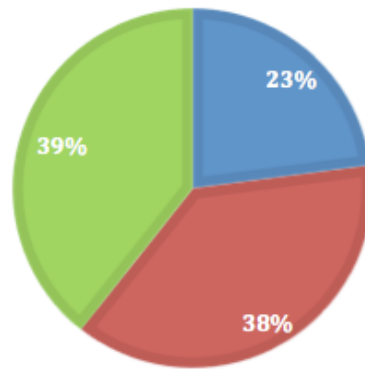
⁴ Klein, C. and R. W. Price. Improving public sector efficiency for more inclusive growth in Latvia. OECD Economics Department Working Papers, No. 1254, OECD Publishing, Paris, 2015 - http://www.oecd-ilibrary.org/economics/improving-public-sector-efficiency-for-more-inclusive-growth-in-latvia_5jrw57p59bxx-en.jsessionid=26legq95q1ln3.x-oecd-live-03.

⁵ *Ib.*, p.17.

⁶ Smidova, Z., OECD Economics Department. Policy areas for increasing productivity in Latvia. Economics Department working papers No. 1255, Paris, 2015, p.19, <http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=ECO/WKP%282015%2973&docLanguage=En>.

THE MAIN RECOMMENDATIONS OF THE REVIEWED FICIL POSITION PAPERS 2006 - 2014 ON MACROECONOMIC AND TAX POLICIES

■ Implemented ■ Unimplemented ■ Further improvements required



2. Matters that need immediate attention

The areas, where it would be necessary to carry out reforms in respect of tax issues, are tax policy, tax administration and shadow economy. The most significant steps at the national level towards an orderly and transparent tax policy in Latvia would be a clear vision and direction of the societal objectives in the tax area, among them:

- 1) establishment of long term tax policy goals;
- 2) improvements in the predictability of the Latvian taxation system;
- 3) increase in Latvia's attractiveness as a holding company jurisdiction;
- 4) competitiveness of payroll taxation system;
- 5) significant reduction of the shadow economy.

3. Recommendations

Improvements in the predictability of the Latvian taxation system

Establishment of long term tax policy goals. Within this recommendation it is absolutely clear that there is a necessity to establish long term tax policy goals in order to maintain the existing taxpayers in Latvia and to attract new ones (foreign investors).

Cooperation, transparency and effective administration. Attention should be paid to possible synergies between improvements in the tax burden structure, governance, and a constructive dialogue between the government and society.

Impact analysis of potential amendments to tax laws. From a legal perspective, thorough impact analysis of potential and sustainable amendments to tax laws should be carried out. Attention should be paid to the Value Added Tax Law amendments by observing principles of transparency, continuity and predictability. Recovering taxes

(CIT and VAT) on bad debts and accelerated introduction of certain optional VAT provisions and the economic advantages that Latvia may gain should be reviewed.

Cooperation with taxpayers. Tax rulings. Transparency and predictability in cooperation with the tax administration, as well as consistency in the opinions and advance tax rulings issued by State Revenue Service and the Ministry of Finance and other suggestions on improving the cooperation between taxpayers and the tax authorities would be discussed.

Tax matters mediation platform. FICIL finds that a significant role in the improvement of the tax system in Latvia would be introduction of alternative dispute resolution to tax dispute administration in the form of an expert group or by using the mediation institute. This recommendation is also important as overall positive motivation to *bona fide* taxpayers.

Increase in Latvia's attractiveness as a holding company jurisdiction

Large investment tax relief concept adjustment. In relation to corporate income tax (CIT) issues on promotion of capital investment in Latvia, CIT relief on R&D and the criteria for application of large investment relief should be revised, at the same time ensuring continuity of such reliefs.

Intra-group loss transfer. At the same time FICIL stands for clearer definitions of business activities in relation to non-profit organizations and allowance of intra-group loss transfer to increase Latvia's attractiveness as holding company jurisdiction.

Transfer pricing. Proper introduction of certain transfer pricing institutes should be more analysed and encouraged, for example, advance pricing agreements⁷ and depreciation of goodwill.

E-commerce in the single market. Fostering of awareness of complex cross border e-commerce businesses within the tax administration.

Competitiveness of payroll taxation system

Payroll taxes. The tax wedge for low-income earners is one of the highest in the OECD. To the extent that high rates are regressive and are both a deterrent to labour market participation (contributing to the large hidden economy via a "participation tax rate") and to formal employment, economic efficiency and equity would be improved by concentrating tax reduction efforts on low-income groups.⁸ Thereby, the commitment to increase competitiveness of payroll taxation concept should be strongly and wisely pursued.

⁷ So far one transfer pricing agreement has been concluded in Latvia on July 8, 2014.

⁸ Klein, C. and R. W. Price. Improving public sector efficiency for more inclusive growth in Latvia. OECD Economics Department Working Papers, No. 1254, OECD Publishing, Paris, 2015, p.18 - http://www.oecd-ilibrary.org/economics/improving-public-sector-efficiency-for-more-inclusive-growth-in-latvia_5jrw57p59bxx-en;jsessionid=26legq95q1ln3.x-oecd-live-03.

Significant reduction of the shadow economy

Fight against tax fraud and tax evasion. Sufficient resources within the tax authority should be professionally allocated to prevent tax fraud. Adequate use of databases and capacity of tax administration⁹ should be strengthened and emphasized as future strengths of the State Revenue Service of Latvia. Stricter law enforcement and tax administration, severer penalties on tax evaders should be observed. Increasing transparency of public spending would be a starting point for an honest discussion with the society in terms of tax administration issues.

Role of customs. Improvements in the effectiveness and competitiveness of the customs regime are necessary, for example, prevention of duty-unpaid cigarette and alcohol supplies from CIS countries.

Excise tax and natural resources tax issues. Different excise tax issues, as well as the implementation of a gradual increase of the natural resources tax rate for specific groups of natural resources and of a moratorium on the tax increase on CO2 emissions should be discussed.

Role of FICIL. The organization continues the work on shadow economy issues together with the Stockholm School of Economics and to be a diplomatic and effective cooperation partner of the Ministry of Finance and the State Revenue Service of Latvia regarding future growth of the country's economy.

In order to achieve more effective cooperation with the involved independent research institutions and for reaching overall best possible result for the Latvia's economy in respect of the audit of Latvia's tax system conducted by the experts of the World Bank, FICIL would be delighted to convey the main conclusions of FICIL's 10 years' work to them as well¹⁰.

According to the European Commission, *"to be able to compete for the best tax policy in the European Union, we need to work together."*¹¹ Thereby, members of FICIL are ready to cooperate with the aim to contribute to the growth of Latvia's economy.

⁹ More than 4000 officials in the State Revenue Service of Latvia.

¹⁰ Please see: <http://www.worldbank.org/en/news/press-release/2016/01/28/world-bank-to-evaluate-equity-and-efficiency-of-latvian-tax-system>.

¹¹ Eiropas Komisija. Ieskats Eiropas Savienības politikā: Nodokļi. Eiropas Savienības Publikāciju birojs, Luksemburga, 2015, 11.lp.