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**DEVELOPMENT OF THE VALUE ADDED TAX SYSTEM IN
THE EUROPEAN UNION AND LATVIA.
PROBLEMS IN APPLICATION AND POTENTIAL SOLUTIONS**

Doctoral Thesis

Riga 2007

GENERAL DESCRIPTION OF THE WORK

Topicality of the theme

Since Latvia's accession to the European Union (EU) it has ever been critical to take active part in the improvement of the tax system. It is particularly true with respect to indirect taxes, to which the value added tax (VAT) belongs, as due to the development of free movement of goods and services among EU member states the tax system applied in the particular member state is gaining in importance in order to ensure fair competition also in transactions between member states.

If prior to EU accession, Latvia was to a great extent obliged to accept the requirements of EU directives and concepts of applying and operating a VAT system formed over a number of years by the "old member states", then nowadays, when Latvia is a fully-fledged EU member state, it is possible to evaluate the existing requirements of directives, identify weaknesses or regulations that are not beneficial for Latvia, perform an analysis of how this system should work more effectively so that it would be more suitable for application in Latvia and other EU member states. However, one must admit that there has been no detailed analysis made in Latvia on the theoretical action of tax and its overall impact on the economics and certain economic indices.

Today, when the EU VAT system has been fully working in Latvia for more than 2 years, it is necessary to further develop this system as the pace of economic growth is extremely rapid, high technologies become more accessible to the public, business community and tax administration, and it calls for continuous improvement and further development of the VAT system because VAT is the tax paid on consumption; thus it applies to every individual and company. In addition, effective tax application is a crucial instrument for generating state budget income, and in 2006 VAT income has exceeded 50% of the total tax income transferred to the state budget. As a result, any changes to the tax system and its application should be assessed in view of at least the following aspects:

- the impact on individuals, their solvency and the social status;
- the potential impact on the business environment in the country; whether administrative requirements will be enforceable; whether such changes will promote further growth of companies; whether fair competition will be ensured in the local and EU market, and on a wider international scale;
- the potential impact *on* the budget income from this tax;
- whether the tax administration will be able to ensure an adequate tax collection and control mechanism.

Evaluation of the VAT system currently applied in Latvia and comparison of its operation in other EU member states reveals quite a large number of deficiencies, errors and factors hindering business activities. Thus, the VAT system requires further improvement, solution of theoretical and practical issues in Latvia and providing our proposals for amending and improving the respective EU directives. In some cases, only minor amendments in a certain normative act or methodology of application result in crucial improvements.

In this respect, Latvia is in a somewhat privileged status because the VAT system has operated in various countries for over a half century. From a global perspective on the common tax system, it is a very short period of time but if compared to the age of the Latvian tax system developed after re-establishment of independence, our country is only in the initial stage of development. And the main advantage is that Latvia can learn from the mistakes made by other countries and avoid making them here, which will ensure more rapid and effective development of the tax system.

In view of the significant role of VAT in the common tax system, especially in generating budget revenue both in Latvia and the EU, the **aim** of this work is to elaborate recommendations, based on a comprehensive analysis of the existing VAT system, for further improvement and development of the VAT system both in Latvia and the EU.

The main **tasks** of research:

- to analyse the historical origin and development of the VAT system and its theoretical aspects, calculation methods and systems of application for obtaining a more thorough understanding of tax application at present;
- to analyse the steps of implementing VAT and its application principles in the European Union and Latvia;
- to perform an assessment of the VAT system, discover issues and deficiencies in the operation and application of the VAT system in Latvia by performing a benchmarking analysis with systems of other EU member states;
- to elaborate potential solutions of the identified problems and determine the necessary directions of further development of the VAT system;
- to elaborate practical recommendations for further improvement and interpretation of normative acts regulating VAT;
- to assess the efficiency of instruments used in VAT administration and their consistency with the current economic conditions, and elaborate recommendations for further improvement of the instruments used in administration.

Research object and subject:

The **object** of research is the value added tax system and related economic, financial, social and practical aspects of application. The VAT system is considered on a wider scale, including its historical development and theoretical methods of application, and the current practical application, by assessing the aspects of VAT operation in Latvia and EU in general, and various branches of economy, as well as on the level of different transactions.

The **subject** of this research is improvement opportunities of the value added tax system, and development of the directions for further development of this tax.

Research methods

This research is based on generally accepted qualitative and quantitative methods of the economic science, including analysis and synthesis, logical constructive, mathematical, statistical and expert evaluations.

Theoretical and methodological basis of the research

The methodological basis of this work represents theoretical and practical findings of scientists from Latvia and other countries on the subject of implementation and application of tax systems and the value added tax. A special mention should be made of the research and development of the EU value added tax system by Ben Terra, Professor of the Netherlands University, as well as his analysis of further practical application.

The work is based on materials issued by foreign and international organizations (including the Organization of Economic Coordination and Development, International Monetary Fund, World Bank), normative acts of the European Union, its member states, including those of Latvia, decisions and meeting minutes of EU institutions, materials of the Central Bureau of Statistics (CBS) of Latvia, conceptual and informative reports elaborated by the Ministry of Finance of Latvia and the Ministry of Economics of Latvia, materials prepared by associations of various branches of economics in Latvia, research materials prepared by international audit firms (KPMG, PriceWaterhouse Coopers, Ernst&Young and Deloitte), handouts of international and Latvian conferences and seminars, as well as the author's experience in the development of the value added tax system in Latvia and drafting acts of legislation, and the area of practical application.

Scientific novelty

Scientific novelty of this work is:

- an assessment of the VAT system applied in the European Union and its implementation process in Latvia, by providing recommendations for further improvement of legislation in terms of implementation and application of the obligatory norms set out in the Sixth Directive;

- development of a formula for tax application and calculation of the deductible input VAT in real estate transactions;
- development of a recommendation for VAT adjustments in relation to bad debts;
- development of a recommendation for VAT application to international passenger transportation services;
- development of recommendations for implementation of the optional conditions of the Sixth Directive, including:
 - VAT application to business activities on an occasional basis;
 - introduction of VAT grouping in Latvia in support of public private partnership (PPP) ideas;
 - determining the place of providing services in transactions with third countries using the so-called "use/enjoyment" rule;
 - application of VAT to lease of railroad carriages to third countries;
 - implementation of special schemes for VAT application in real estate transactions;
 - VAT application in import of goods;
- Development of a brand new scheme for introducing the common VAT in transactions between EU member states to replace the current reverse charge method, as well as the requirement to register as a VAT payer in several member states;
- Analysis of the European Commission (EC) recommendations for further improvement of the VAT system on cross-border transactions and development of recommendations for further improvement of the VAT system, including:
 - Implementation of the one-stop scheme;
 - simplification of the VAT refund procedure;
 - Improvement of the conditions for deducting input VAT;
 - Widening the application of the reverse charge scheme;
- Development of recommendations for changes in the normative basis and practical application of the tax penalty system.

Thesis

- The VAT system introduced in Latvia operates primarily in line with the principles laid out in the Sixth Directive; however, certain requirements contradict the norms of the Sixth Directive and the economic essence of the tax included therein;

- Latvia has not made sufficient use of the so-called "optional conditions" provided by the Sixth Directive which may result in significant improvements in the business environment without impacting budget revenues from this tax or burdening tax payers or the tax administration with additional administrative duties;
- Latvia applies extremely heavy and inflexible administrative procedures of tax application and formal non-compliance to them or failure to comply to the letter are often the basis for punishing the tax payer without consideration of the reasons for non-compliance and the amount of loss incurred by the budget.

Approbation and practical use of the key results of this research

The key results of this Doctoral Thesis have been presented and discussed in scientific discussions, several international conferences, national and international seminars.

The results of this research have been used in the drafting of the law "On Value Added Tax" of the Republic of Latvia and preparing many draft amendments to this law which have been ratified by the Saeima or are under various development and acceptance stages, Regulations of the Cabinet of Ministers that explain the procedure of applying the norms of the law "On Value Added Tax", and other regulations of the Cabinet of Ministers explaining legal norms. The above normative acts or draft acts have been developed under the author's guidance while acting as Director of the Tax Policy Department of the Ministry of Finance from 1997 to 2003, and certain results of the Doctoral Thesis are included in the author's recommendations submitted on behalf of the Association of Tax Consultants of Latvia to the Ministry of Finance, State Chancellery, Tax and Budget Commission of the Saeima from 2003 to date, and which have been fully or partially incorporated in the respective normative acts, including:

- recommendations developed in various periods of time on the opportunities to apply reduced tax rates are included in the law "On Value Added Tax", which has resulted in the introduction of the 5% rate for medicinal products, public utilities, books, mass media, and other goods and services;
- recommendations on VAT application on passenger transport services have been incorporated in the law "On Value Added Tax", resulting in the 0% rate applied to international passenger transport services and the reduced 5% rate applied to inland passenger transport services;
- recommendations on granting entities the rights to deduct input VAT from expenses incurred before registration with the SRS's register of VAT taxable persons have been elaborated in the amendments to the law "On Value Added Tax" effective as of 1 January 2006;

- recommendations for improvement of the penalty system have been included in the law "On Value Added Tax" by decreasing the amount of penalties in the cases of reverse charge and limiting the possibilities to make surcharges in case a person is eliminated from the VAT register, as well as in the draft law "On Taxes and Duties" which results in a crucial decrease of tax penalties;
- proposals and recommendations for potential implementation of the optional conditions of the EC Sixth Directive in Latvia have been elaborated in the informative report of the Ministry of Finance of 26 May 2006 "Optional conditions in the application of the value added tax discussed in the EC Sixth Directive of 17 May 1977", resulting in prospective development of normative acts aimed at introducing VAT grouping, options in VAT application in real estate transactions, potential adjustments to VAT based on bad debts etc.

Results of this Doctoral Thesis relating to the tax penalty system in Latvia and its further development, controversial VAT issues and development of the Latvian VAT system in the EU context have been presented at the annual international conferences "Audit, Tax and Accounting" in 2003, 2004, and 2005.

Publications

The results of this Doctoral Thesis have been published in Latvian scientific, economic and business professional publications:

1. Kauliņa G., Krastiņš A. Nekustamā nodokļa reforma un nodokļa turpmākās attīstības iespējas (The reform and further development options of real estate tax). Rīgas Tehniskās universitātes zinātniskie raksti. (Riga Technical University scientific papers) 3. sērija - Ekonomika un uzņēmējdarbība. (Series 3 - Economics and business) Tautsaimniecība: teorija un prakse. (Economics: theory and practice) Volume 3. RTU Publishing house, Riga, 2002, pages 56-64.
2. Andrējeva V., Birums A., Kauliņa G. Nodokļu konvencijas - pamatdokuments nodokļu administrāciju starptautiskajai sadarbībai (Tax treaties - the basic documents for international cooperation of tax authorities). State Revenue Service. Nodokļu administrēšanas un muitas stratēģiskā loma tautsaimniecības attīstībā. (The strategic role of tax administration and customs in the development of economics) Starptautiskās zinātniski praktiskās konferences zinātniskie raksti. (Scientific papers of the international scientific and practical conference) Riga, 17 December 2003 RTU Publishing house, Riga, 2003, pages 14-18.
3. Kauliņa G., Krastiņš A. Pievienotās vērtības nodokļa piemērošana pasažieru pārvadājumiem Latvijā un citās Eiropas valstīs un tā ietekme uz Latvijas pasažieru pārvadātāju konkurētspēju (VAT application to passenger transportation in Latvia and other EU member states, and its impact on the competing capacity of the Latvian passenger carriers). Riga Technical University, Faculty of Engineering Economics. Tautsaimniecības un uzņēmējdarbības attīstības problēmas (Development issues in economics and entrepreneurship) Starptautiskās

konferences zinātniskie raksti (Scientific papers of the international conference)
Rīga, 9-11 October 2003 RTU Publishing house, Rīga, 2004, pages 135-143.

4. Kauliņa G., Andrējeva V., Krastiņš A. Uzņēmumu ienākuma nodokļa attīstība Latvijas nodokļu sistēmā (Development of corporate income tax within the Latvian tax system). Rīgas Tehniskās universitātes zinātniskie raksti (Riga Technical University scientific publications) 3. sērija - Ekonomika un uzņēmējdarbība (Series 3 - Economics and business) Tautsaimniecība: teorija un prakse (Economics: theory and practice) Volume 9. Publishing house "RTU", Rīga, 2004, pages 52-59.
5. Kauliņa G. Application of VAT to Cargo Transportation Services in Latvia. Mykolas Romeris University. Jurisprudence. Not yet published.
6. Kauliņa G. Ko nosaka pēdējie grozījumi likumā "Par pievienotās vērtības nodokli" (What do the latest amendments to the law "On Value Added Tax" state) - Grāmatvedība un Revīzija, 2004/1 - pages 12-17.
7. Kauliņa G. Pievienotās vērtības nodokļa piemērošana darījumiem ar precēm pēc Latvijas iestājas Eiropas Savienībā (VAT application to transactions with goods after EU accession of Latvia) - Grāmatvedība un Revīzija, 2004/2 - pages 2-7.
8. Kauliņa G. Pievienotās vērtības nodokļa piemērošana pakalpojumiem no šā gada 1. maija (VAT application to services after 1 May 2004) - Grāmatvedība un Revīzija, 2004/3 - pages 10-15.
9. Kauliņa G. PVN piemērošana transporta pakalpojumiem (VAT application to transport services) - Bilance, No 17 (101), 9.2004. - pages 4 - 7.
10. Kauliņa G. Izglītība PVN žņaugos (Education in VAT tourniquet) - Saldo, No 2 22.09.2004. - pages 12-13.
11. Kauliņa G. Par izdevumiem, kas paredzēti apliekamo darījumu nodrošināšanai (On expenses for ensuring taxable transactions). - Bilance, No 23 (107), 12.2004. - pages 9-10.
12. Kauliņa G. Strīdīgie jautājumi PVN piemērošanā (Disputable issues in VAT application). Latvijas Ekonomists, No 1 (121), 2005. -pages 9-10.
13. Kauliņa G. Jaunie nosacījumi pievienotās vērtības nodokļa uzskaitē (New provisions for VAT accounting) - Grāmatvedība un Revīzija, 2005/1 - pages 2-5.
14. Kauliņa G. PVN piemērošanas izmaiņas šajā gadā (Changes in VAT application in 2005) - Grāmatvedība un Revīzija, 2005/2 - pages 2-7.
15. Kauliņa G. Jaunie MK noteikumi par PVN piemērošanu (New Cabinet of Ministers Regulations on VAT application). - Grāmatvedība un Revīzija, 2005/4 - pages 10-14.
16. Kauliņa G. Par ko maksāsim nodokļus un cik daudz (For what and how much we shall pay). Bilances Gadagrāmata 2006. - pages 26.-33.
17. Kauliņa G. Neskaidrības jauno PVN likuma normu piemērošanā (Ambiguity in the application of the new VAT norms). Bilance, No 1 (133), 1.2006. - pages 8-10.

- 18.Kauliņa G. Soda sistēma par nodokļu pārkāpumiem Latvijā (The penalty system for tax violations in Latvia) Latvijas Ekonomists, No 1 (133), 2006. - pages 19-22.
- 19.Kauliņa G. Jaunumi un problēmas PVN piemērošanā (News and problems in VAT application). - Grāmatvedība un Revīzija, 2006/2 - pages 14-21.
- 20.Kauliņa G. Jaunie grozījumi PVN likumā prasa jaunus skaidrojumus (The new amendments to the VAT law call for new explanations). Bilance, No 14 (146), 7.2006. -pages 4-5.

Reports and participation at scientific conferences, workshops and seminars

1. „Latvijas nodokļu sistēma starp Eiropas valstu sistēmām." (The Latvian tax system in the context of EU member state tax systems) Sixth International conference "Audit, Tax and Accounting 2003", Riga, 2003.
2. „Strīdīgie PVN piemērošanas jautājumi." (Disputable issues in VAT application) 7th International conference "Audit, Tax and Accounting 2004", Riga, 2004.
3. „Sodu sistēma par nodokļu pārkāpumiem Latvijā un tās pašreizējā attīstība." (The penalty system for tax violations in Latvia and its current development). 8th International conference "Audit, Tax and Accounting 2005", Riga, 2005.
4. „Latvijas nodokļu sistēmas attīstība ES kontekstā." (Development of the Latvian tax system within the context of EU) 9th International conference "Banking and Finance 2003", Riga, 2003.
5. „Nodokļu likumdošana un finanšu vadība." (Tax legislation and financial management) 10th International conference "Banking and Finance 2004", Riga, 2004.
6. „Fiskālie stimuli un savstarpējā sāncensība attiecībā uz ārvalstu tiešajiem ieguldījumiem." (Financial incentives and competition related to direct foreign investments) OECD organized conference in Lithuania (Vilnius), 29 - 30 May 2000.

Scope of work

This Doctoral Thesis represents an independent scientific research prepared in the Latvian language and containing the following chapters and subchapters:

1. HISTORICAL DEVELOPMENT, THEORETICAL DESCRIPTION AND CALCULATION METHODS OF VALUE ADDED TAX

1.1. Historical origins and development of VAT

1.2. Theoretical description of VAT, and systems of application

1.2.1. Theoretical description of VAT

1.2.2. Systems of VAT application

1.3. VAT calculation methods

- 1.3.1. Direct VAT calculation methods
- 1.3.2. Indirect VAT calculation methods

2. IMPLEMENTATION AND APPLICATION PRINCIPLES OF VALUE ADDED TAX IN THE EU AND LATVIA

- 2.1. Implementation of VAT in the EU
- 2.2. Requirements for VAT application in the EU, their implementation in Latvia and necessary improvements
 - 2.2.1. VAT taxable transactions, scope of tax
 - 2.2.2. VAT taxable persons
 - 2.2.3. Place of transaction
 - 2.2.4. Chargeability of VAT, and time and right of deducting input tax
 - 2.2.5. Taxable value of transactions
 - 2.2.6. Exemptions from VAT
 - 2.2.7. Value added tax rates

3. OPTIONAL CONDITIONS INCLUDED IN THE SIXTH VAT DIRECTIVE AND THEIR APPLICATION IN LATVIA

- 3.1. Applying the status of a taxable person to performers of business activities on an occasional basis
- 3.2. VAT grouping in public private partnership schemes
- 3.3. Application of optional conditions to the sales of assets
- 3.4. Place of delivery of services. Application of use/enjoyment rule
- 3.5. Adjustment of taxable value for VAT application to bad debts
- 3.6. Reduced VAT rate, its application to food and energy resources
 - 3.6.1. Reduced VAT rate for food
 - 3.6.2. Reduced VAT rate for energy resources
- 3.7. VAT application in real estate transactions
- 3.8. Special conditions for VAT application to international passenger transport services
- 3.9. VAT application in import transactions

4. DIRECTIONS FOR FURTHER DEVELOPMENT OF VALUE ADDED TAX

- 4.1. Implementation of the one-stop scheme
- 4.2. Review of the refund of VAT paid in another country
- 4.3. Rights to deduct input VAT, necessary regulations
- 4.4. Application of the reverse charge system, potential directions for further development
 - 4.4.1. Extension of the reverse charge system
 - 4.4.2. Introduction of common VAT in transactions between EU taxable persons
- 4.5. Simplification of VAT responsibilities for small and medium-sized entities
- 4.6. Distance sales, expected changes in the system

5. ADMINISTRATIVE REQUIREMENTS AND PROCEDURES IN APPLICATION OF VALUE ADDED TAX

- 5.1.Registration and deregistration of persons in the register of VAT payers
 - 5.1.1.Procedures for registering with the register of VAT taxable persons
 - 5.1.2.Deregistration from the register of VAT taxable persons
- 5.2. Requirements for documenting taxable transactions
- 5.3.The penalty system for tax violations in Latvia
 - 5.3.1.General description of the penalty system
 - 5.3.2.Penalties for violation of VAT normative acts
 - 5.3.3.Further development of the tax penalty system

This Thesis contains Conclusions and Recommendations, as well as 7 appendices. The Thesis contains 25 figures, 20 tables, 7 formulas, and the total page count is 249. The Bibliography contains 174 sources of reference.

KEY SCIENTIFIC OUTPUTS OF THE RESEARCH

1. HISTORICAL DEVELOPMENT, THEORETICAL DESCRIPTION AND CALCULATION METHODS OF VALUE ADDED TAX

The first part deals with historical origins and development of the value added tax (VAT) in the world and Latvia, and the place and importance of the tax in the context of the general tax system development.

Although VAT, as we understand it today, has been established only during the last century, the origins of the tax in the form of applying certain payments to goods under various stages of production and sales, date back to the very early years when the humanity started living together. Studies reveal that a general turnover tax was applied to goods sold in markets and auctions already in the ancient Rome. This system was later used also in Egypt, France, Spain and other countries.

The modern turnover tax which is used as the basis of VAT was most often implemented to cover the damage caused by war and crisis, which is evidenced by the time when this tax was implemented in different countries. For example, in Germany, France and Belgium this tax was implemented during World War I, while in England - in 1940 in order to cover the expenses on World War II.

Analysis of the formation and development of the tax system in Latvia indicates that indirect taxes (customs tax in particular) have been a very significant source of revenues during the First Independent State of Latvia. During 1920-ies and 1930-ies this tax accounted for over half of all the budget income of the country.

In today's Latvia, the primary reason why this tax was implemented without much contemplation and detailed analysis was the Latvia's foreign policy objective to accede to the European Union (EU), and one of the conditions to reach this objective was harmonization of the tax system, including introduction of a common customs system and harmonization of the indirect tax system.

After reviewing today's tax systems in different countries of the world, one can say that an increasing emphasis is being laid on the application of indirect taxes. When making tax reforms countries tend more often to implement the value added tax because of the nature of this tax, its economic effectiveness, its significant capacity of revenue generation, in view that this tax is less competition mutilating compared to other types of indirect taxes, because of its neutrality, fairness, as well as relatively small costs of administration.

In Latvia, this tax has to be assigned a very significant role in generating tax revenues. When considering the amount of revenues paid in the budget as VAT, one can see that revenues generated by VAT grow not only in absolute numbers but also their percentage of total state budget revenue tends to increase, and in 2006 it exceeded half of all tax revenues in the state budget (refer to Table 1).

Table 1

VAT revenues in the state budget of Latvia [data from the State Treasury]

	2004	2005	2006 (planned)	Actual in 9 months of 2006
Total taxes, LVL mln	1 010.9	1 356.0	1 624.4	1 276.9
Indirect taxes, LVL mln	745.7	1 019.9	1 230.2	949.9
VAT, LVL mln	486.7	677.1	830.1	644.1
VAT % of all taxes	48.1	49.9	51.1	50.4
VAT % of indirect taxes	65.3	66.4	67.5	67.8
VAT as % of GDP	6.6	7.3	8.8	X

As this research is primarily devoted to VAT analysis, its previous development and application in Latvia and EU, as well as to potential further development of this tax, it is necessary to have a detailed analysis of the nature of this tax, its characteristics, specifics, and calculation methods. No VAT nature and description can be given without looking at its predecessor, i.e. the turnover tax. Therefore, this thesis provides a description of turnover tax as a **neutral universal or general indirect consumption tax**, and discusses the potential collection systems for this tax.

This thesis deals also with the tax calculation methods. Four different methods can be used for VAT calculation, including direct addition method and indirect addition method, and direct subtraction method and indirect subtraction method or credit method.

Indirect subtraction method or the **credit method** is treated as a universal method for tax calculation. Under this tax calculation, it is permitted to deduct from the tax calculated on supplied goods (services) the tax for purchased goods (services). The credit method may be expressed by the following formula:

$$N = (L \times I) - (L \times C),$$

where N - calculated tax;
L - tax rate
I - all sales income;
C - all expenses for generating sales.

The value added tax calculations in EU and Latvia are performed in accordance with the credit method.

2. IMPLEMENTATION AND APPLICATION PRINCIPLES OF VALUE ADDED TAX IN THE EU AND LATVIA

Part two of the thesis presents an analysis of VAT implementation in the EU and the key application principles in the EU Member States, which are compared with VAT application in Latvia. Analysis is made of activities starting from 1960 when the first activities commenced with respect to implementing a common turnover tax in the EU Member States, accepting the first five VAT Directives and their requirements, as well as elaborating the basis for development and implementation of the Sixth VAT Directive which is still the basis for VAT application in all EU Member States.

The Council Sixth Directive of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value-added tax: uniform basis of assessment (hereinafter - the Sixth VAT Directive) was accepted in order to harmonize the different national taxes of EU Member States. Although the preamble of this Directive mentions liquidating fiscal borders among EU Member States as one of the objectives for introducing the Directive, it is only on 16 December 1991 when amendments were passed to the Sixth VAT Directive (91/680/EEK) that actually provided for liquidating fiscal borders. This Directive finally introduced transition regulations for facilitating trade among Member States starting from 1993.

This chapter provides an assessment of the main requirements of the Sixth VAT Directive that determine the application of the tax in EU Member States, analysis of the application of those requirements in Latvia and their impact on the tax payer, requirements of administration, and budget revenues.

For the analysis of **VAT taxable transactions** and the scope of tax, the author has created a transaction scheme for VAT purposes (refer to Figure 1).

According to that scheme, all transactions are divided for VAT purposes into three large groups with different tax application, deduction of input tax and disclosure of tax in the returns:

- taxable transactions with involvement of practically only taxable persons (with certain known exceptions);
- tax exempt transactions that may be performed by taxable persons without applying the tax but with disclosures in the VAT return, and non-taxable persons without registering the transaction for VAT purposes;
- transactions outside the scope of VAT that may be performed by any person and that should not be disclosed in the VAT return.

For the purposes of the value added tax, there is a defined **concept of the taxable person**. Regulation of the Sixth Directive is different from the understanding

applied in Latvia. The Directive states that a taxable person is any person independently performing business activities in any place irrespective of purpose and results of activity, while the Latvian law "On Value Added Tax" (VAT law) contains a different regulation as the basic requirement is being registered with the register of VAT payers.

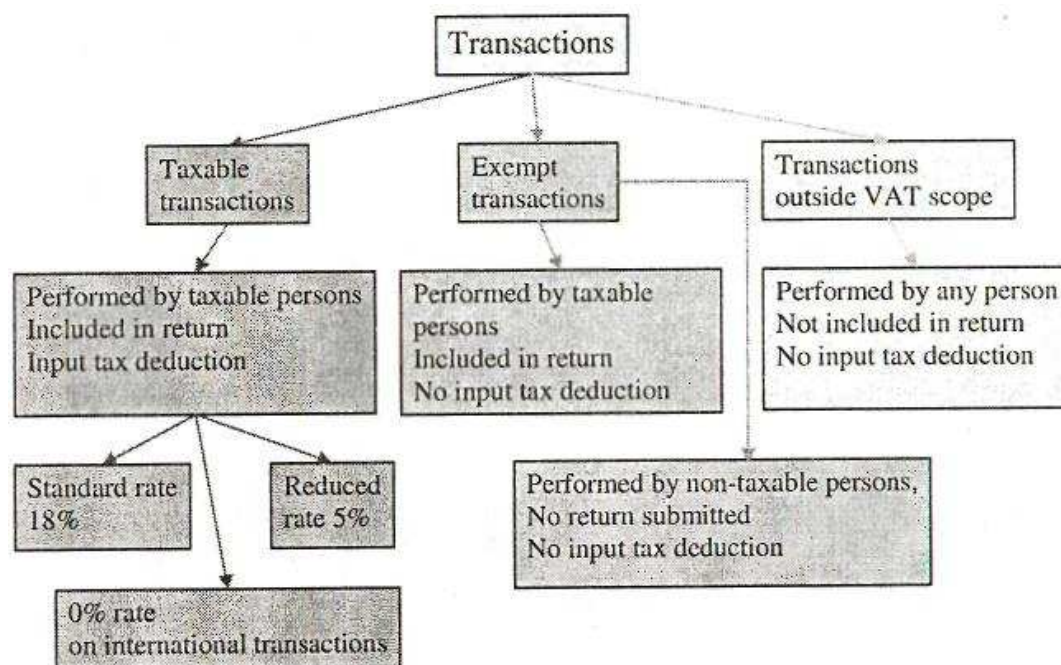


Figure 1. Classification of transactions for VAT purposes.

A different interpretation is applied in Latvia also to the understanding of business activity. In Latvia, this term denotes any systematically performed activity against remuneration, while in the Directive, this term bears a wider understanding - business activity means also long-term use of tangible or non-tangible assets in order to gain income, as well as activities related to purchase of goods and fixed assets that will be later used for generating income. It means that there should be no restriction of rights to deduct input tax for persons who have been purchasing respective goods or services to be used for commencement and performance of business activities. Latvian tax authorities still restrict the deduction of input tax in such cases although the European Court has repeatedly ruled in favour of tax payers in such cases (European Court judgements 268/83, C-1 10/94, C-396/98 etc.).

For the purpose of effecting administration, before commencing business activities all taxable persons should register in a register of taxable persons created by the tax administration especially for this purpose, receive a registration certificate of a

taxable person and a registration number of a taxable person. In Latvia, there is a set threshold for registration - the amount of taxable transactions being 10,000 LVL over a period of 12 months requires obligatory registration, while voluntary registration as a taxable person is allowed before reaching this amount.

The Sixth VAT Directive does not provide for such a threshold. However, it must be noted that only a few Member States (such as Belgium, Italy, Sweden, the Netherlands, Hungary) have not set such thresholds. The majority of current Member States have set registration thresholds and they are very different. Figure 2 summarizes data on obligatory registration thresholds in different EU Member States.

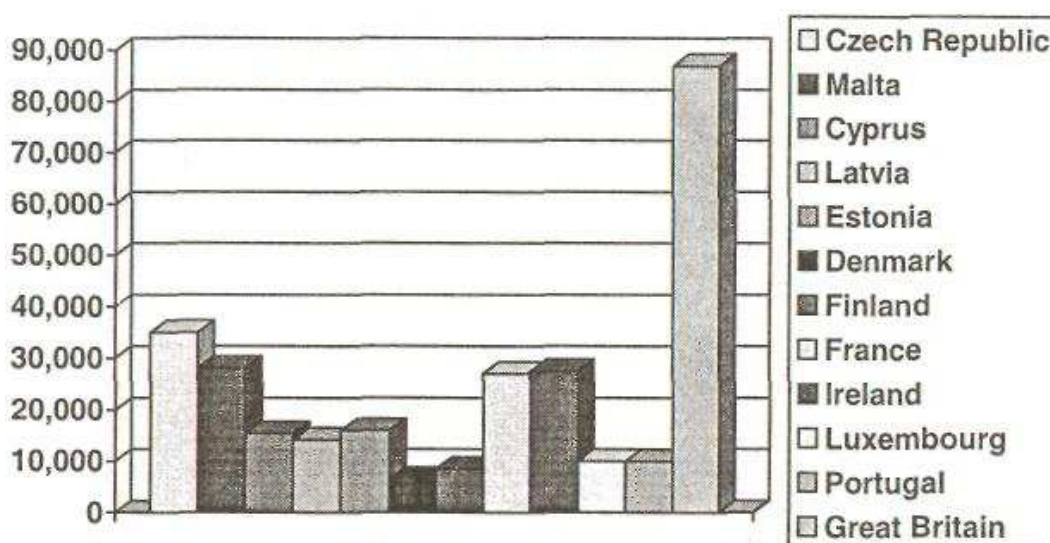


Figure 2. Registration thresholds in various EU Member States (EUR).

An important precondition for correct tax application is accurate determination of the place of transaction, as the place of transaction actually determines in which country the tax should be applied and which tax rate should be selected for the transaction in question.

According to the Sixth VAT Directive, the **place of delivery of goods** is determined based on the location of goods at the date when the delivery or transportation commences. In practice, tax application is not as straightforward as this condition applies only to the initial part of goods delivery transaction, and it should always be followed by an assessment of additional conditions. Figure 3 depicts the author's created scheme for determining the place of delivery of goods.

If goods are delivered from Latvia to a person in another EU member state, the Latvian taxable person should assess the status of the recipient of goods. To that end, there is a common comprehensive data base of tax payers in the EU containing

information on the registered tax payers in all Member States (VIES - VAT Information Exchange System).

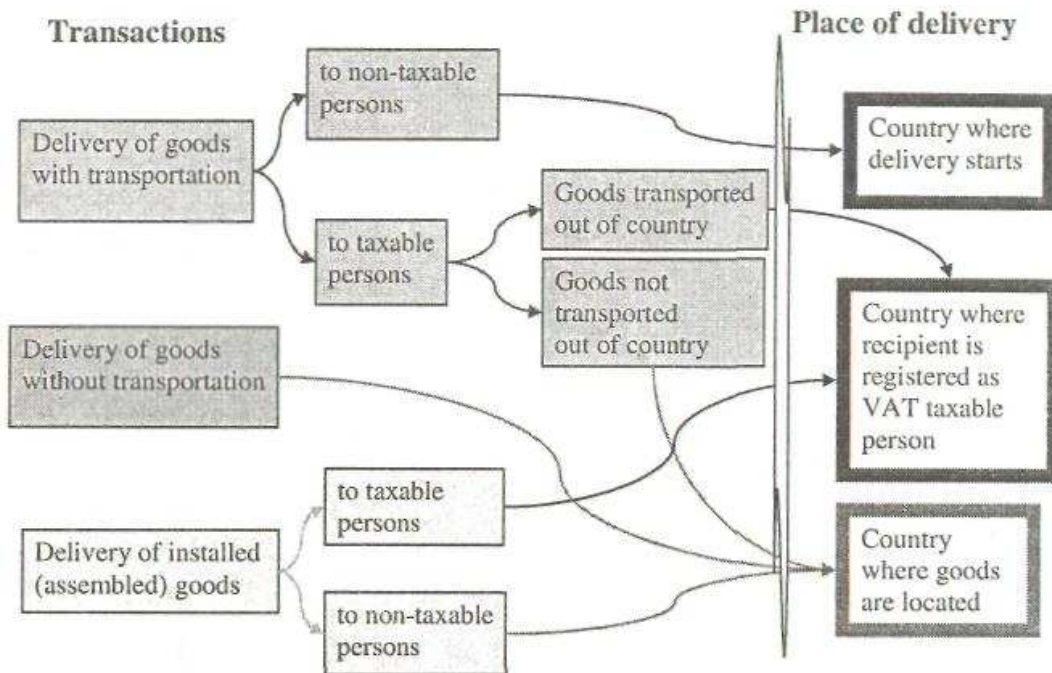


Figure 3. The scheme for determining the place of delivery of goods.

Determination of the **place of provision of services** should be based on a number of conditions. Depending on the type of services, taxation is performed by the provider's legal address, recipient's legal address or the actual place of provision of services.

In Figure 4, the author has depicted how the place of provision of services should be determined for VAT application. Through application of the following scheme, it is ensured that double taxation is avoided and tax evasion is prevented. However, this scheme has certain deficiencies, including:

- 1) as not all the EÜ Member States have a precisely formulated place of provision of certain services, it is both possible to evade the tax and have a double taxation of the particular transaction;
- 2) in provision of certain services, a similar kind of tax evasion is possible with transaction partners registered in third countries;
- 3) there is a number of services the place of provision of which is determined by the actual place of provision, which means that the provider of services should register

as a VAT payer in each of the countries and comply to the administrative requirements for tax application in the respective country.

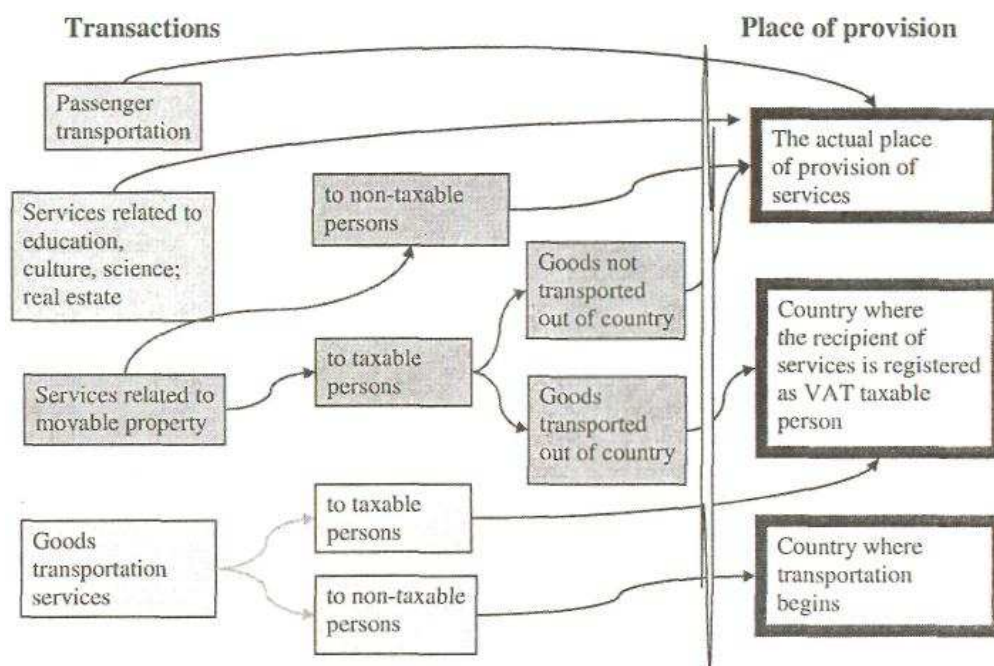


Figure 4. The scheme for determining the place of provision of services.

At the moment, both in the Sixth VAT Directive and Latvian legislation acts there are strict regulations with respect to the **moment of performing the taxable transaction or chargeable event**. This is a question that was not addressed in the Latvian legislation for quite a while. Only after EU accession, legislation was complemented with a regulation on the time of applying tax and deducting input tax. The basic requirement for deducting input tax states that the tax becomes deductible on the date it has become payable. It is logical also in terms of the state budget because only by complying to this condition one can say that the tax is neutral with respect to its payers.

This thesis analyzes also the conditions for **determining taxable value**. An inconsistency has been noted between the regulations included in the Sixth VAT Directive and the Latvian VAT law, as in Latvia more emphasis is laid on the market price of goods or services while taxable value in the EU is determined in accordance

with the value of the transactions to be paid. A description is provided on effective exemptions from tax and applicable **rates**, by comparing the requirements included in the Directive and their practical application in different Member States.

It has been noted that in many of the so-called "old" EU Member States (EU-15) there is often a lack of full compliance to the Sixth VAT Directive with respect to application of reduced rates, such rates being applied to transactions not provided for by the Directive. It is explained by the specific norms of national laws in existence prior to making respective amendments to the Directive, and it is customary to issue a special directive which determines the transition period for harmonization of legislation with the requirements of directives, and sets deadlines for implementation, which actually are often extended. At the same time, countries that acceded EU in 2004 (EU-10) were not allowed practically any deviations from the Sixth VAT Directive in this respect. The only deviations were noted in the taxation of heat energy where transition periods of various lengths have been allowed for Estonia, Lithuania, Czech Republic and also Latvia, which had an extension of the tax exemption for one year, as well as for Poland with respect to certain agricultural products.

In addition, one must note that only the Baltic states have not made use of the reduced tax rate for food. Almost all other Member States have used this opportunity.

3. OPTIONAL PROVISIONS INCLUDED IN THE SIXTH VAT DIRECTIVE AND THEIR APPLICATION IN LATVIA

Besides the obligatory requirements which have to be implemented by the EU Member States in their national legislations, the Sixth VAT Directive also includes VAT application norms that in certain cases permit Member States to opt one of the possible tax regimes (hereinafter - optional provisions). Part 3 of the thesis deals with the potential implementation in Latvia of such optional provisions which may be supportive in the author's opinion.

The analysis made by the author proves that it would be useful to implement in Latvia the optional provision of the Sixth VAT Directive to apply tax to certain transactions performed by non-taxable persons without the requirement for such persons to register in the VAT register, and apply the status of a taxable person only to certain transactions. Contrary to the opinion held at the Ministry of Finance that implementation of this condition would result in an increased administrative burden for such persons and more complicated tax administration, the author believes that introduction of this condition would provide benefits for both parties, as law abiding persons:

- will not have to register and perform all registration procedures;
- will not have to prepare returns and perform submission procedures in the period when transactions are not made;

- will not have to perform procedures that SRS requests of persons de-registering from the register;
- will not have to take risks of being punished in case the SRS discovers the existence of such transactions.

Introduction of such a condition would also promote compliance with law and administrative procedures as it would encourage persons to legalize this kind of transaction because upon taxing a transaction it would be possible to deduct a previously paid tax. Whereas, the administrative burden of SRS would decrease for the reason that it would only be necessary to administer concrete transactions performed by non-taxable persons and that have the necessary supporting documents submitted, rather than performing registration and de-registration procedures, and constantly following the submission and review of the empty or so-called "zero returns". It would also decrease the risk for such taxable persons who perform business activities on an occasional basis that their assigned VAT numbers be used for fictitious transactions.

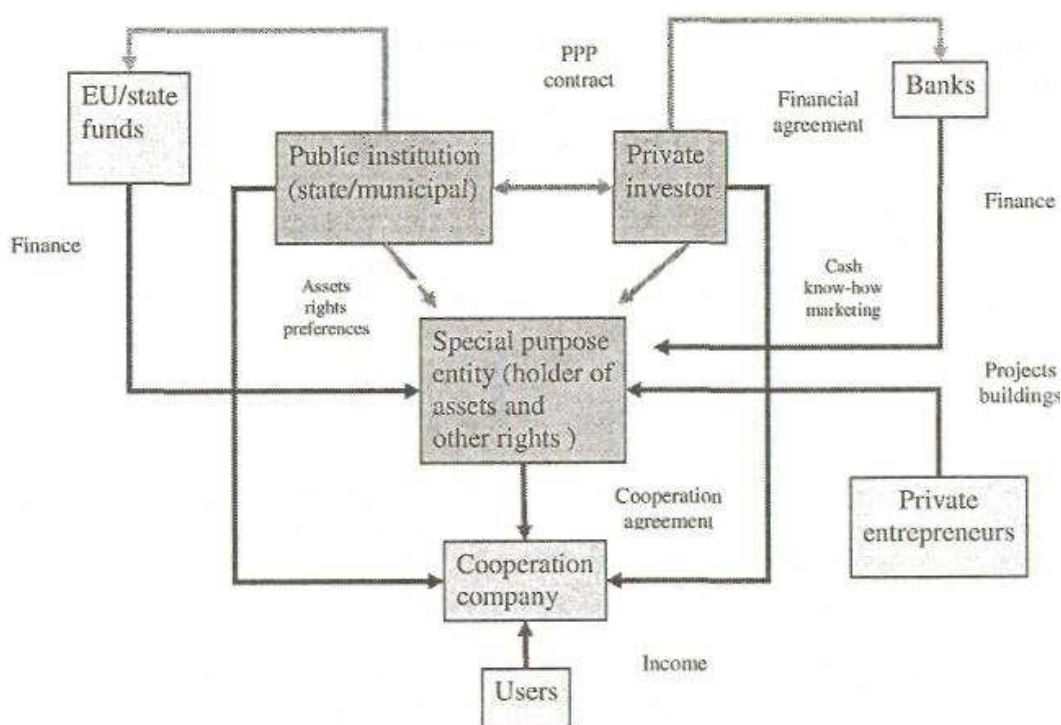


Figure 5. The potential model of PPP.

The Sixth VAT Directive permits that Member States may treat as separate taxable persons such persons who are registered in the territory of this country and

who being legally independent are closely connected to each other by financial, business and organizational bonds, which enables the so-called VAT grouping. The Thesis proposes to use the grouping option in development of public private partnership (PPP) ideas (Figure 5 discloses one of the potential PPP operation models). International experience shows that in the majority of cases PPP is an effective means for construction and maintenance of the infrastructure objects or providing certain services required for the public, while in Latvia this form of cooperation to date has developed rather slowly, and elaboration and introduction of an appropriate encouraging tax regime may be the required incentive for successful further development of PPP.

The Thesis provides a comparison of VAT impact on costs under traditional procurement schemes and PPP when a VAT group is established for implementation of a concrete project such as building a new school. Under the traditional procurement scheme applied today (refer to Figure 6), one can see that the builder issues an invoice to the municipality and includes in the value of building services the costs of materials and the value of his work, and the planned profit. As a result, the entire cost of materials, labour and profit is subject to VAT paid by the municipality through the use of credit resources obtained against interest payments.

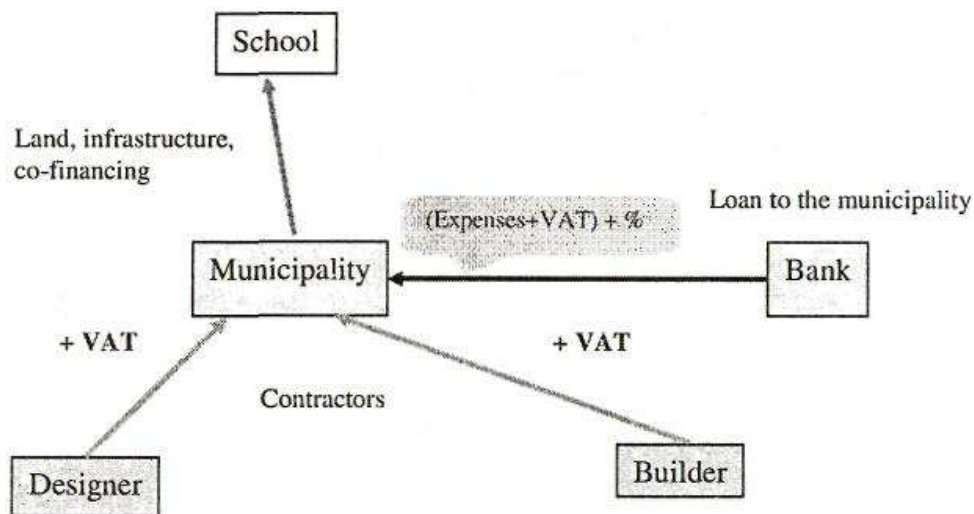


Figure 6. Public procurement scheme.

From Figure 7, one can see that building of the school involves a private partner who performs the function of a project developer and participates in project financing. In order to decrease the impact of VAT on the total project costs, a VAT group is established including the municipality, private partner and builder which results in higher project costs. By not applying VAT within the established group, project costs are decreased by the amount of VAT that relates to the value of building services

provided and calculated profit. The only VAT impact under this scheme is presented by the value of goods supplied to the builder because the tax paid by the builder cannot be deducted as input tax since the services received and goods purchased are not used for performing taxable transactions, as well as VAT paid for the project development. As a result of establishing a VAT group, there is a saving of funds that can be set by the following formula:

$$IE = 8\% [(B-PR) + P],$$

Where IE - savings of funds,

B - total cost of building,

PR - goods purchased, services received by the builder,

P - builder's profit

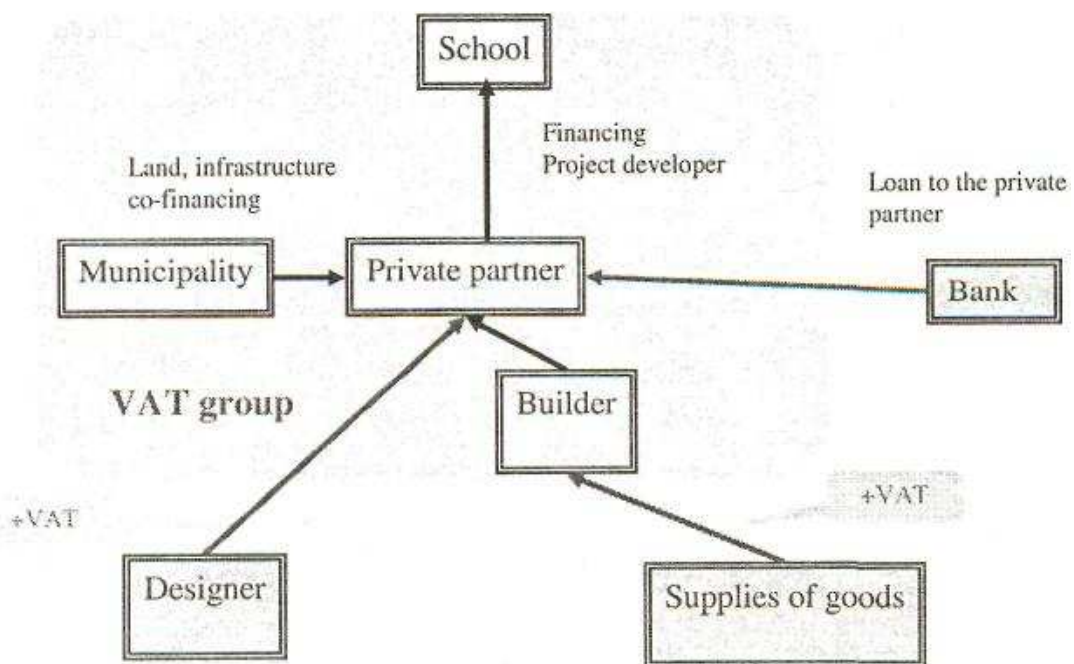


Figure 7. Scheme of the PPP model with VAT grouping.

This formula includes only the direct VAT impact, because a VAT group is established; however, an indirect saving of costs will arise from decreasing credit resources attracted for project implementation. A general assessment of the structure of costs shows that taxable goods and services used by the builder during a project implementation typically do not exceed 50% of total project costs, therefore, by implementing the proposed VAT application scheme one can say that it may be possible to have a saving of 9 - 10% of total project costs.

The thesis provides analysis of options not to apply the tax to **sales of part of assets**. As the business environment of Latvia grows increasingly active, transactions

related to sales of a company, of a totality of assets or part thereof, become more and more popular. The Latvian legislation provides VAT exemption only for transactions of sale of a company or part of assets in the event that shareholders of the company change. However, in transactions where shareholders of a company do not change but a part of former assets is sold with all pertaining rights and obligations, legislation treats it as a simple sale of property (supply of goods).

If Latvia introduced an option not to apply the tax to sales of assets, taxable persons would have a smaller burden of administrative requirements both with respect to maintaining accounting registers and issuing complicated tax invoices. The taxable person who sells a part of his assets would not have to pay the tax to the budget, while the taxable person who purchases this part of assets would not account for input tax and struggle to receive a refund of it. However, the largest benefit would be free funds that would not have to be frozen for tax payments.

The author has performed an analysis of **options for VAT adjustments** in cases of **bad debts** and offers a scheme for making such adjustments (refer to Figure 8).

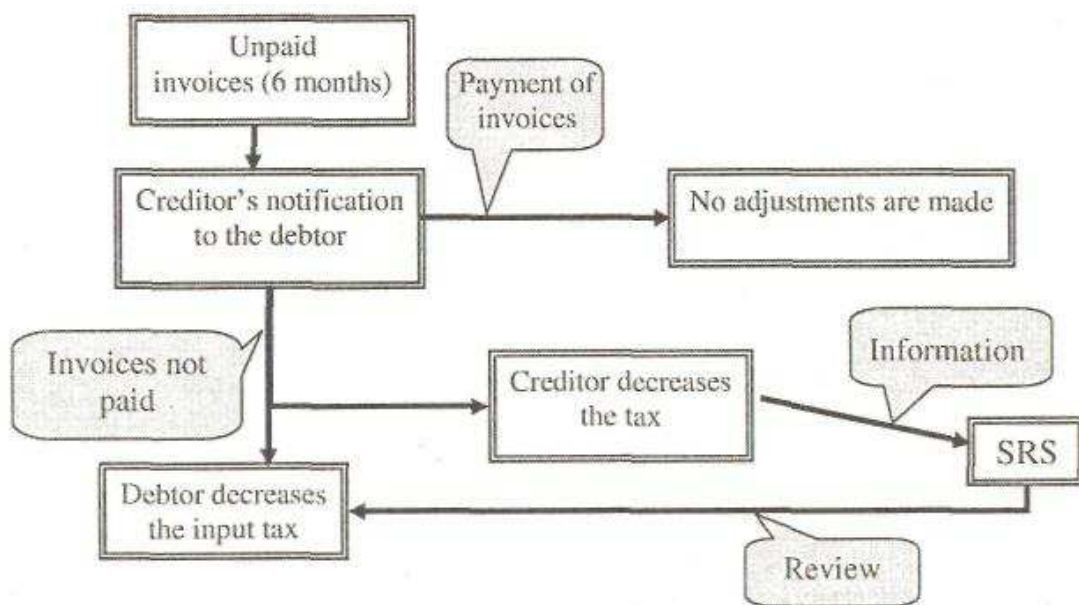
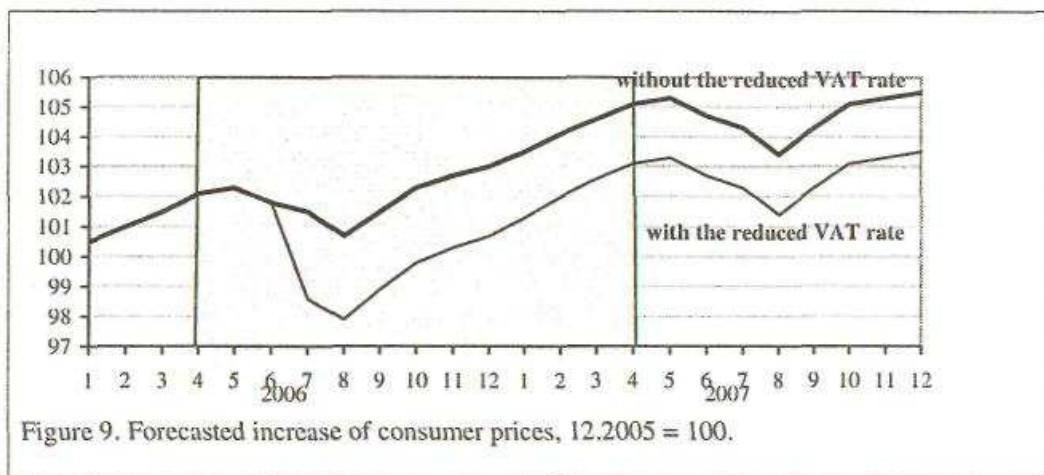


Figure 8. VAT adjustments on bad debts.

This Thesis analyses the options to introduce a special regulation for determining the place of provision of certain services by using the **rule** of use/enjoyment, in order to avoid double taxation, tax evasion or hindering of competition in transactions with partners from third countries. The author has substantiated that special norms should be introduced in Latvia with respect to telecommunication services, lease of movable property and services provided to non-

taxable persons of third countries who do not perform business activities. Also, analysis includes the question of applying optional provisions to services of vehicle lease, with respect to services of leasing commercial vehicles. The proposal is to apply the tax depending on the country where the vehicle is used. As it is not difficult to obtain evidence of the above when the EU border is crossed, it would be reasonable not to apply the Latvian VAT to lease services of the commercial vehicles that are used outside the EU territory. The most critical aspect in this respect is that the entrepreneurs of third countries have practically no possibility to obtain a refund of VAT paid in Latvia, which means that the cost of such services for the foreign customers will inevitably be higher by 18%.

As mentioned earlier, Latvia is one of the three EU Member States that do not apply the **reduced VAT rate for food**. This Thesis includes the analysis of the impact of applying the reduced rate for food on the inflation, price of food and budget revenue, by using the assessment performed by the Ministry of Economics. According to the above, if the VAT 5% rate would have been applied to food as of 1 July 2006, consumer prices would have decreased by approximately 2 basic points compared to 2005 (refer to Figure 9).



Although the research carried out by the Ministry of Economics indicates at a significant decrease in the budget revenues in the event of introducing the reduced VAT rate for food, the author believes that Latvia should continue considering a gradual introduction of the VAT 5% rate, and start applying it to certain most widely used products, and gradually extend the application, which would not result in a rapid decrease in the budget revenues, rather it would in time equalize the tax impact on the price as compared to other EU Member States.

This Thesis includes also an analysis of the option to apply the reduced VAT rate to electricity and natural gas. Supply of **electricity and natural** gas in Latvia is

subject to the standard VAT rate of 18% both for individuals and other consumers until the end of 2006.

There is a constant increase in the prices for electricity and natural gas in the world, and it is based on the increased prices for energy resources. Decrease of the VAT rate on the supply of electricity and natural resources to individuals in Latvia would slightly decrease the speed of increasing prices, and the reduced VAT rate would partially compensate the increase in tariffs on electricity and natural gas paid by individuals. It would have a beneficial effect on low-income individuals who find payments for natural gas and electricity significant (refer to Table 2).

Table 2

The impact of applying the reduced VAT rate for the supply

Rate	Impact on the tariff (percent)	Impact on the budget revenue (million LVL)	Impact on inflation (basic points)
Natural gas:			
12%	-5.1	-0.9	-0.03
9%	-7.6	-1.3	-0.05
5%	- 11.0	- 1.9	-0.07
Electricity:			
12%	-5.1	-3.3	-0.11
9%	-7.6	-4.9	-0.17
5%	-11.0	-7.2	-0.24

The **supply of heat energy** to individuals in Latvia was exempt from VAT since the date of introducing VAT up to 1 July 2006. Such a VAT application regime has been in contradiction to the applicable conditions of the Sixth VAT Directive, which means that Latvia was actually in violation of this Directive until the above date. In accordance with the derogation provided in the Accession Agreement of 2003, this type of VAT application was allowed for Latvia only until 31 December 2004. The Thesis includes an analysis for the impact from introducing the reduced VAT rate on the prices for this product and budget revenue.

The Sixth VAT Directive envisages that in certain branches and transactions the respective country may allow tax payers to choose the most beneficial tax regime. In this respect, the author has analysed **transactions connected with real estate**.

To date, Latvia has not introduced special norms for transactions with real estate neither with respect to ensuring the choice of options for tax payers, nor with respect to a state determined regime. In practice, it is very difficult to calculate the tax

payable into the budget and the amount of input tax. The author has elaborated a formula which may be used by entrepreneurs in order to calculate the amount of deductible input tax if the real estate is not sold during 10 years of the date when it was put into operation.

$$BP = [SP / 10 \times (10-n) - SP / 10 \times (10-n) \times (ND / KD)] - [AP / 10 \times (10-n)],$$

where BP - deductible input tax;

SP - total input tax paid;

ND - value of non-taxable transactions;

KD - value of total transactions;

AP - total input tax deducted;

n - the number of years from the date of putting into operation until the sale of real estate.

However, the situation is much more complicated when the tax has to be applied to a partially renovated building that is used for both taxable and non-taxable transactions. In that case, no formula can be derived as there are no standard situations.

The author has analysed the option to have a flexible VAT application to transactions with real estate depending on the status of the estate and the status of the persons involved in the transaction. For example, if the sale of a used real estate used for taxable transactions was permitted to be taxed:

- the seller would obtain full rights to deduct the input tax as no proportion would have to be applied and the price of the real estate would decrease;
- the purchaser could acquire real estate for a price excluding tax, and although the tax would have to be paid initially, it could be deducted as input tax;
- state budget would gain for a short period the paid tax which has not been deducted yet;
- tax administration and tax payers would benefit from a simplified tax administration as there would be no time consumption on the proportion calculation;
- business environment in the country would improve, as well as the competing capacity of companies.

In addition to the above, the author proposes to exempt from tax the sales of such unused real estate that will be used for social, health protection, cultural and educational purposes, or for individual consumption such as residing, and that is purchased by non-taxable persons. It would not significantly change the VAT payments on the apartment market but it would slightly decrease the costs of building social, cultural and health protection objects, and notably simplify the accounting and calculation procedures for correct tax application.

A specific situation has formed in **the passenger transportation**, as regulation of the directive is different from the actual tax application in the EU Member States. As a result of the author's research submitted by the Ministry of Transport for review at the Cabinet of Ministers, a decision was made that starting from 1 May 2004 passenger transportation in the public transport in Latvia will be taxed at the reduced VAT rate of 5%, while international passenger transportation will be taxed by the VAT 0% rate in order to ensure similar tax application as it is in the majority of Member States.

The Thesis analyzes the situation in VAT application to **import** transactions. Research proves that it would be beneficial to apply in Latvia the option provided for by the Sixth VAT Directive not to collect the tax at the moment of actual import of goods but disclose it in the monthly tax return. This would ensure an equal treatment in this respect of local tax payers compared to importers of goods from other EU Member States, who currently have a possibility to use an intermediary and import goods through Latvia and make no actual tax payments on the EU border.

4. DIRECTIONS FOR FURTHER DEVELOPMENT OF VALUE ADDED TAX

Part 4 of the Thesis deal with analysis of the recent year activities by the EU institutions with respect to issues connected with further development of VAT in the EU with the key emphasis on transactions among several Member States and the potential implementation of the proposed solutions in Latvia. The current transitional provisions of the Sixth VAT Directive partially address these problems; however, the procedures are heavy and bureaucratic which is a quite common reason for refraining from such transactions at all, which undeniably hinders business development in the EU Member States. It does call for solutions how to facilitate cross-border transactions and ensure taxes are paid and control facilities exist.

Currently the taxable person who performs certain transactions in several Member States has to register as a VAT payer and fulfil all VAT liabilities (maintain registers, submit reports, make payments) in each of the Member States. Under review has been a possibility to fulfil tax liabilities in accordance with a one-stop scheme which provides that persons are registered for VAT purposes only in one Member State, i.e. the country of residence, and according to procedures set in the legislation, inform the tax authorities of their country of residence about the transactions carried out in other Member States. Under the one-stop scheme, the taxable person will have to make tax payments directly to each country of consumption.

In order to provide taxable persons with information for simultaneous tax application in several Member States, for example, on the VAT rates in each Member States for concrete transactions, it is necessary to establish a system for consistent exchange of information among the tax administrations and make it available to tax payers for planning and organizing their activities.

The electronic information exchange system may be integrated in the VIES in order to modernize it and facilitate the availability of information to tax administrations.

One of the most significant obstacles and restrictive factors in cross-border transactions is the rather complicated and lengthy procedures that currently have to be made in order to **obtain a refund of the tax paid in another member state** on goods and services purchased for ensuring business activities. Although the refund is theoretically governed by the Eight VAT Directive and it should be harmonized across all EU Member States, certain refund procedures, required documents and the actual time of obtaining the refund is different across Member States. A different approach is used by Member States also with respect to purchased goods and services that are eligible to a refund and in which cases the refund is refused. The most notable differences among EU Member States relate to the VAT refund for such goods and services that present difficulties in determining the potential need for business activities or individual consumption such as purchase or lease of automobiles, costs of using the vehicles (fuel, repairs etc.), expenses on residence and food etc.

At the moment, there is a proposal in the EU to modernize the current **tax refund procedure** without changing the basic principles. According to the proposed procedure, refund requests would continue to be the responsibility of the country where VAT is paid, the amount of refund would be determined in accordance with the rules of the member state where expenses were incurred, and payments would be made by this Member State directly to the requesting taxable person from another Member State. However, the proposed changes related mainly to the submission of requests. It is provided that the taxable person will submit his refund requests to his own tax administration (in the country of residence). Then, through the use of the tax administration it will be ensured that the request is forwarded to the Member State where the actual expenses were incurred. The country of residence would perform an initial review of its own taxable person. This initial review would actually replace the current certificate by which the country of residence confirms the status of a taxable person. Data transfer from the tax administration in the country of residence to the tax administration of the Member State which makes the refund would be a confirmation that the request has been made by an active taxable person.

Transformation of the current procedure into an electronic one, including dividing the review function between the country of residence and the country where expenses were incurred, would result in less work to Member States implementing the

refund procedure and relieve tax payers from some of their responsibilities. As a result, the time for processing requests could decrease from the current 6 months to 3 months, which would improve cash flows in the respective company.

Alongside the necessity of changing the current input tax refund procedure set in the Eight VAT Directive, it is necessary to consider the issue of the specific types of expenses that could be deductible and the types of expenses that could not be subject to a full VAT refund. In order to ensure that documents submitted in one country correspond to the regulations in effect in the other country which will make the input tax refund, it is absolutely critical that the understanding of refundable and non-refundable input tax is similar in both countries. It can be achieved by harmonizing national regulations which at the moment are very different. Only by harmonizing those regulations, deductions can be made in accordance with the regulations effective in the country of residence.

By implementing the above mentioned tax refund scheme, one could also resolve the issue of applying a proportion to the determination of the refundable tax as there is a situation when a taxable person who is permitted in his country of residence to deduct an input tax only from a small portion of the tax amount paid, may receive a refund of the full tax amount paid in another member state.

With respect to transactions carried out between Member States at the moment there are 3 different types of tax application:

- By the legal address of the supplier of goods or provider of services (the country that issued the provider's VAT number);
- By the legal address of the recipient of goods or services (the country that issued the recipient's VAT number);
- By the physical location of goods or provision of services which requires an obligatory registration for VAT purposes in the respective country if it is different from the country of residence of the provider of services.

This Thesis analyzes two different potential further solutions for VAT application to transactions:

- In order to avoid the obligatory VAT registration in more than one country, under consideration is a possibility to further extend the reverse charge scheme;
- In order to avoid the previous violations and deficiencies that are possible when applying the reverse charge method, a suggestion has been prepared to introduce a new procedure for tax application in transactions between VAT taxable persons registered in different EU Member States.

The author has developed a new scheme that has not yet been publicly discussed and which would help avoid problems arising from the application of the

reverse charge system in transactions between Member States including the extensive possibilities to commit fraud, at the same time not burdening tax payers with heavy administrative procedures. One of the possible alternative ways is to introduce a common VAT for such transactions in all EU Member States. A common VAT in this respect should mean a common procedure for tax application to certain transactions in all EU Member States, application of a common tax rate, and common administrative procedures (chargeability and payment time of tax, executing invoices) ensured by national administrations of Member States in close cooperation with each other.

The tax rate for such transactions should be selected such that would be most acceptable to all Member States. It could be the average or most frequently used rate in the EU Member States, for example, 19% or the lowest permissible tax rate 15% as specified in the Sixth VAT Directive. Preferable is the 15% rate as it would have the least impact on the cash flows of companies.

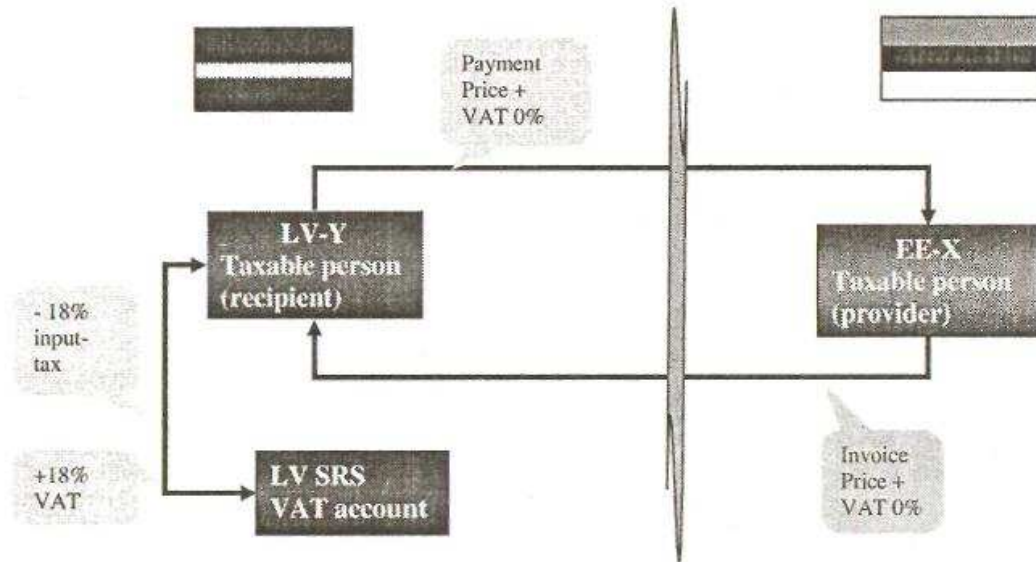


Figure 10. Reverse charge scheme.

The current effective reverse charge scheme is provided as Figure 10. The proposed new "common VAT" scheme depicted as Figure 11 could be applied to all transactions carried out by taxable persons in different Member States and that currently are applied the reverse charge method, as well as other transactions that at the moment require registration in other EU Member States. It is not advisable to apply this scheme to transactions that require significant purchases in another EU

member state (country of non-residence) and transactions with real estate. The performers of such transactions should better register in the respective Member State for VAT purposes in order to ensure a timely refund of input tax.

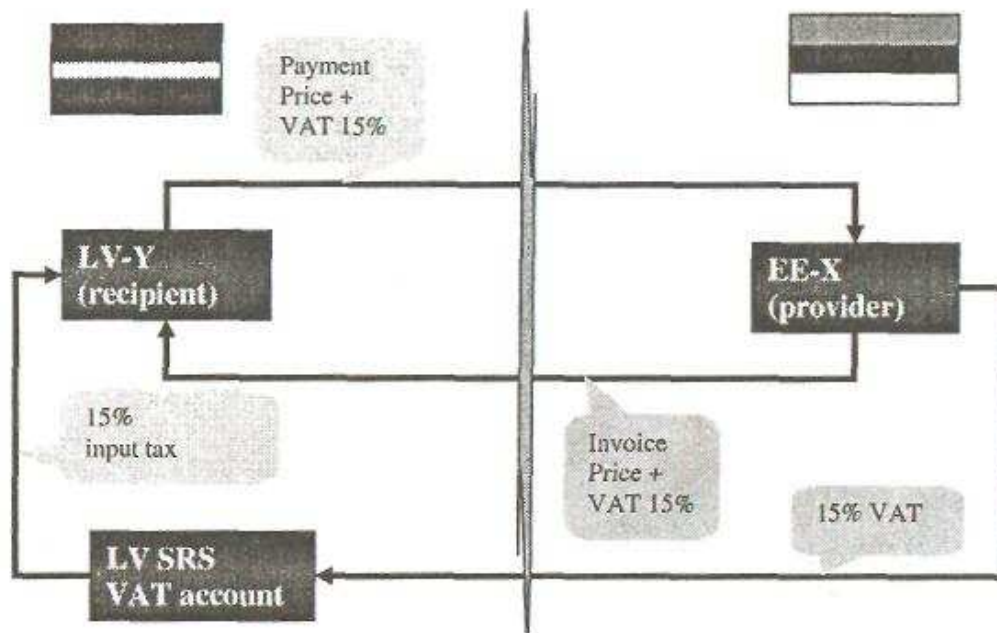


Figure 11. Scheme of common VAT.

The basic precondition for application of this scheme is that all international transactions are applied a common rate, the tax is actually collected from the recipient of the goods/services, and paid into the budget of the recipient's country. The transaction is reflected in the supplier's VAT return but the recipient may deduct the paid tax by disclosing it in his return. The proposed common VAT application scheme has a number of positive aspects, while there are certain drawbacks too.

The **positive aspects** include the following:

- The provider of services does not have to study the national legislation of the residence country of the transaction partners in order to find out whether he has to register in that country;
- The provider of services does not have to register in another EU Member State (in the example - Latvia), and does not have to become a taxable person of that country and fulfil all administrative requirements connected with this tax;
- An explicit tax rate of 15% is applied and no studies should be made of legislation of another country and specific requirements therein;

- Fraud is limited as there is a balance between inland transactions and transactions among Member States. Since the recipient of services has to pay the tax to the provider of services who transfers it to the budget, the procedure of tax payment is the same as for any transactions carried out inland, except that there is a different tax rate. As a result, no schemes will be set up to deliberately evade tax payments, organize provision (or receipt) of services by using VAT registration number of other countries, or providing the advantage of receiving equivalent services to entrepreneurs of other countries. The difference between the proposed 15% rate and the rate effective in the respective country would give a minor fiscal impact and would not promote creation of risky schemes;
- The recipient of services does not have to make formal entries and tax calculation in the return by applying a reverse charge scheme where the fiscal effect most often is 0. Discontinued is the current widely-applied practice when a taxable person calculates the reverse tax on all instances when a payment has to be made to another country or an invoice is received with the 0% rate applied;
- Member State budget revenues increase on the account of transitionally paid and not yet deducted tax amounts;
- The chosen common VAT rate is practically neutral with respect to the existing rates of Member States because by applying it to transactions between taxable persons the rights of deductible input tax make the tax applied neutral;
- The system is also applicable to transactions with non-taxable persons who perform business activities. The proposed system could be quite successfully applied to distance sales where recipients of goods are also non-taxable persons who do not perform business activities.

As mentioned earlier, the proposed system also has certain **drawbacks**, including the following:

- Taxable persons who receive goods or services under the new scheme will have to pay a certain amount as a tax to the provider of services which is later deducted as an input tax but it has an impact on the company's cash flow;
- The provider of services has to pay the actual tax to the budget of the recipient's country;
- In order to administer taxes, tax administrations should keep an updated data base on the bank account of each Member State for transferring VAT, as well as maintain regular contacts with tax administrations of other countries to ensure, when required, an efficient exchange of information on transactions, transferable tax payments and the amount of taxes to be deducted;
- This tax is relieving for taxable persons who receive services using the common VAT for non-taxable transactions or for non-taxable persons who receive services.

It may cause distortions of competition in countries where the common tax rate significantly differs from the national standard rate of tax, for example, in Sweden and Denmark where the standard rate is 25%.

Table 3 presents a benchmarking analysis of the reverse charge scheme, requirement to register and application of the new common VAT.

Table 3

Benchmarking analysis of the reverse charge scheme, requirement to register and application of the new common VAT

	Reverse charge	Registration in several Member States	Common VAT
Legislation in Member States	Must be known, double taxation or tax evasion is possible	Legislation of another country has to be known very well	Only the VAT payment account of the foreign country has to be known
Competition regulations	More beneficial to select a foreign supplier	No impact	No impact
Cash flow in the company	No impact	The tax is actually payable in all countries	The tax is transferable to another country account
Additional administrative expenses for the company	Minimum	Significant, ensure registration, filing returns, completing reports, maintain records	Minimum - only payment of tax to a foreign account
Tax administrations involved	Both countries. For the provider - check the basis for 0% rate, for recipient, check the reverse charge application	Full administration procedures in both countries.	Country of residence + payment accounting in the country of recipient
Budget revenue	No impact	Increases on the account of cash flow	Increases on the account of cash flow

In order to be able to implement the common VAT on international transactions, Latvia should propose this system to the respective EU structures when the decision is made on the development of new norms of directives and introduction of administrative measures for improving tax collection and preventing fraud. Tax introduction would require an acceptance from all countries, but this kind of acceptance is hard to achieve as seen in the recent past, because countries are not

willing to accept new changes and tend to retain their customary practices and current developments. Likewise, it would be necessary to develop a system for payment control but it could be similar to the system required for introduction of the previously discussed one-stop scheme.

The Thesis analyzes the possibility to further increase the threshold required for obligatory VAT registration. At present, the Sixth VAT Directive sets sufficiently stringent regulations when entrepreneurs should become VAT payers. According to this directive, Clause 24, point 2 (a), the set threshold is 5,000 euro. This threshold sets the amount of annual turnover when the entrepreneur must become a taxable person. However, one must note that in practice the approach to this question is significantly different as the majority of Member States have requested and received a permit to increase this threshold materially.

Analysis is also made of the EU proposed level for registration in order to perform distance sales. The new threshold will be provided in order to exclude from registration persons who do not perform systematic distance sales. The European Commission proposes to set the threshold in the amount of EUR 150,000. In the author's opinion, such a threshold would be too high for Latvia as it may impact competition.

5. ADMINISTRATIVE REQUIREMENTS AND PROCEDURES IN APPLICATION OF VALUE ADDED TAX

Latvia is distinguished from other Member States by very strict administrative regulations for tax application. In addition, the formal requirements set out by our country's tax administration increase year by year, which is evidenced by the research carried out by the Latvian Investment and Development Agency on various administrative obstacles that hinder development of entrepreneurship in Latvia.

Part 5 of the thesis includes the author's analysis of procedures to be performed by entrepreneurs in order to register in the VAT payers' register. It is noted that the procedure is inadequately complicated and subjective and it should be reviewed. It is obvious that this procedure is carried out in order to prevent registration of fictitious persons and the primary objective of it is to identify responsible persons; unfortunately, in Latvia this objective is not achieved through the use of procedures in place.

Also, the requirements for executing taxable transactions are analyzed in the Thesis. The basis of VAT accounting and calculation is VAT invoices that are used to determine the amount of tax paid to the budget and the input tax. Correct execution of issued and received invoices is a key condition for further tax application and recognizing transactions as complete for VAT purposes. After comparison of the requirements included in the Latvian VAT law and the Sixth VAT Directive one must

admit that those requirements are quite similar and homogeneous. However, one must note that there are significant differences in the attitude towards the use of incompletely executed invoices for VAT purposes expressed by different tax administrations in the EU Member States. If the majority of Member States does not assign it a decisive importance and primarily request that the invoice disclose the transaction partners and the essence of the transaction, i.e. its value and the tax calculated, then in Latvia, the lack of even a formal entry is sometimes used as the basis for denying deduction of input tax.

A very significant role in tax application in Latvia is played by the registered way-bills invoices introduced in Latvia, which beginning with 2006 are basically replaced by invoices bearing SRS issued numbers. The author doubts the usefulness of receiving such numbers in general, as well as the introduced procedures to be performed in order to obtain, account and report on the usage of such numbers. Likewise, doubtful is the necessity of details on goods transporting documents as required by the acts of legislation, such as information on the pricing of goods, discounts applied, and calculations of taxes, including natural resources tax, excise tax etc.

Table 4

Penalties for violations of legal norms incorporated in various tax laws

Violation	Taxes, duties	CIT	PIT	Social contributions	VAT	Real estate tax	Excise tax	NRT
Decrease of the tax amount	100%*	TD***	100%	300%	100%	NN	NN	200%
Repeated violations	200%**	TD	-	-	TD	TD	TD	-
Delayed tax payments	Ref. rate 4% +0.05%	TD	Ref. rate 4% +0.05%	TD	NN-currently 10% of 2006	TD	TD	TD
Non-submission of return	0,1% - 1% ≤ 500Ls	TD	-	-	TD or de-registration	TD	TD	-
Specific penalties	-	-	1 Ls- 100 Ls	5 Ls per person	18%- 200%	30%	Confiscation etc.	4-12 rates

* - as of 1 January 2007, 30% - 50%

** - as of 1 January 2007, 100% - 150%

*** - according to the law "On Taxes and Duties"

The goal of any tax administration in any country is to ensure collection of taxes set by legislation and budget revenues, as well as prevent evasion from tax payments. For this purpose, different countries use different instruments:

- Measures for informing, training and error analysis of tax payer's characteristic of Scandinavia and also Estonia.
- Measures related to penalty application for violations of tax laws. These instruments have been assigned an undoubted preference in our country, and it is reflected both in the analysis of acts of legislation, and the practical application of penalties.

At the moment, the general types of penalties for tax violations (including for decrease of tax bases and amount, repeated violations, unregistered business activity, non-submission of declarations, delayed tax payments) are set in the law "On Taxes and Duties". However, there is still a number of penalties incorporated in special purpose tax laws which provide for specific penalties in the case of specific tax violations (refer to Table 4).

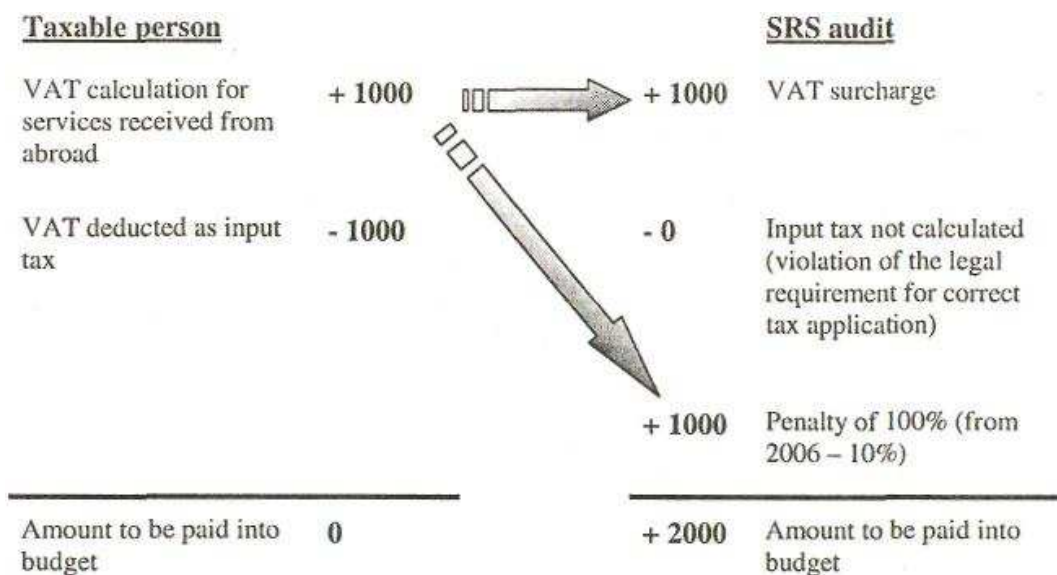


Figure 12. VAT reverse charge method on services received from third countries.

Difficulties may arise in connection with application of penalties set in other normative acts as the expected changes will not reach there. The largest share of specific penalty sanctions is incorporated in the law "On Value Added Tax". An explicit example of inadequate application of penalties in practice is the penalties applied for non-performance of the so-called reverse charge.

If such a violation was discovered during an audit, State Revenue Service used to calculate tax without regard to the tax payer's right to deduct input tax, and surcharged a penalty (until the end of 2005, for transactions with companies from third countries - 100%, from 1 January 2006 - as 10% of the total amount of transaction). As a result, the entrepreneur has to pay a penalty of 110% to 200% for non-performance of a formal entry which does not decrease the amount paid into the budget at all (refer to Figure 12).

Another inadequate penalty is exclusion from the register of VAT payers. For example, exclusion from the register is also provided for in cases when a person has not submitted the tax return in the respective period of time or has not replied to SRS requests. The author believes that exclusion from the register should not be applied as a penalty for violations of a formal nature; however, when a person should be excluded from the register being fictitious, its business activities should also be discontinued in order not to promote lawful tax evasion if the person continues to perform business activities.

Table 5

Calculation of late payment penalty for VAT purposes

Regulating normative acts	Penalty for delay as set in law	Calculated penalty if delay is one month	Calculated penalty if delay is 10 months
Until 31.12.2005 Law "On Taxes and Duties"	Increase of principal - BoL refinancing rate (4% p.a.) Late payment penalty 0.05% for each delayed day	Increase of principal - 0.3% Late payment penalty - 1.5% Total- 1.8%	Increase of principal -3.3% Late payment penalty- 1.5% Total- 18.3%
From 01.01.2006, law "On VAT"	10% of tax amount	Penalty - 10%	Penalty- 10%
Impact		The amount of penalty increases 5.5 times	The amount of penalty decreases 1.8 times

As of 1 January 2006, new requirements have come into force with respect to penalties for inclusion of the calculated VAT in the return of the post-taxation period or inclusion of input tax in the return of the pre-taxation period. If for the delay of all

other taxes (including VAT up to now) a late payment penalty was applied which was calculated as 0.05% for each delayed day applying also the Bank of Latvia refinancing rate (in 2006 - 4%), then in the case of VAT delay from the beginning of 2006, the law provides for a 10% penalty irrespective of the length of delay, which stimulates long-term non-payment of taxes (refer to Table 5).

The Thesis analyzes the further development of the tax penalty system. Starting from 2007 it is expected to simplify the calculation of late payment penalty without the refinancing rate and determining only the late payment penalty for a certain period. The total tax burden will also be decreased by differentiating penalties in the range 30 - 50% depending on the amount of unpaid tax as opposed to the total tax payable. However, at the same time it is not expected to make changes in other tax laws in order to agree and assess the norms of liability. As a result, it is expected that in 2007 there will be a situation in Latvia when violations of a similar nature committed in calculation of different taxes will result in different penalties.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions:

1. The value added tax system implemented in Latvia operates basically in line with the principles set in the EU Sixth VAT Directive, and this tax corresponds to the characteristics of a general indirect consumption tax. The process of tax implementation and further improvement may be treated as positive while there are still certain norms in effect both in the Latvian tax regulating normative acts and the practical application of the tax that contradict the norms of the Sixth VAT Directive, including the nature of the tax therein. With respect to introducing the obligatory norms of the Sixth VAT Directive in Latvia the following can be concluded:

1.1. Insufficient regulation exists in Latvia in the area of regulating taxable/non-taxable transactions. It specifically concerns donations and various charity activities. The Latvian legislation does not differentiate donations neither by purpose, nor by amount, therefore any donation for VAT purposes will be treated as a transaction subject to tax or if not subject to tax then no input tax deduction is permitted. This causes certain difficulties for entrepreneurs to engage in charity undertakings or make donations, including to the institutions of the social sphere.

1.2. There is no regulation in the Latvian legislation to determine the moment of tax application and deducting the input tax in transactions effected by the use of an escrow account.

1.3. The Latvian legislation has insufficient regulations on the rights to deduct input tax on traveling, hotels, restaurants, use of automobiles and residence, etc. In order to deduct an input tax one must prove that these expenses are connected with performance of taxable transactions. In order to prevent subjective attitude towards this type of expenses, it is necessary to introduce a more specific regulation.

1.4. The Latvian normative acts have an insufficient regulation with respect to determining taxable value of a transaction, especially in cases when various discounts are applied, and bonuses, gifts, coupons are provided etc.

2. There are certain issues that are not addressed or have a conflicting treatment in the Sixth VAT Directive itself. The most frequent contradictions in the practical application of the tax include the following:

2.1. The Sixth VAT Directive does not set the threshold of transaction amounts for obtaining the status of a taxable person, except for the norms that permit small companies not to become taxable persons if their annual turnover does not exceed EUR 5,000. It means that a person should theoretically become a taxable person on the very date he starts business activities. In fact, almost all Member States have set an obligatory threshold when a person should become a tax payer, and this threshold is significantly higher than the one mentioned in the Directive.

2.2.The Sixth VAT Directive does not contain a precise formulation of the place for providing marketing and management services, and the Member States apply different regulations. As a result, there are cases when such services are taxed both in the provider's and the recipient's country of registration, and cases when those services are taxed in neither of the countries involved in the transaction. Although Latvia has developed such a regulation, in transactions with taxable persons from other EU Member States double taxation or non-application of taxes is possible.

2.3.Through the application of certain norms of the Sixth VAT Directive and repeated extension of their application, the old Member States (EU-15) are permitted long-term derogation from the Sixth VAT Directive in respect of relieves from VAT application and applying the reduced rate, which results in unfair competition in certain branches of business activity.

2.4.The regulation of the Sixth VAT Directive on VAT application to international passenger transportation services is different from the tax application practice in all EU Member States. In addition, the norms of the Directive contradict the norms of transitional provisions, while in practice neither is applied to the full extent. As a result, the initially set VAT application procedure in Latvia caused worse competition environment than the VAT regime applied in other EU Member States. At present, the applied VAT regime is the same as the practice used in the EU; however, it does not comply with the requirements of the Sixth VAT Directive.

3. Latvia has not made sufficient use of the so-called "optional provisions" provided by the Sixth Directive which may result in significant improvements in the business environment without impacting budget revenues from this tax or burdening tax payers or the tax administration with additional administrative duties, including;

3.1.In Latvian, it is not permitted to apply the states of a taxable person to performers of business activities on an occasional basis, and such persons have to become permanent VAT taxable persons and must complete all administrative duties despite the fact that they perform only occasional VAT taxable transactions.

3.2.Latvia has not introduced and implemented VAT grouping, which would permit to decrease the amount of administrative duties for taxable persons, by not applying the tax within the group and performing a common tax accounting for all persons involved in the VAT group. Particular benefit from such grouping would be provided to persons who are involved in large joint projects if the group contains VAT taxable and non-taxable persons, who would decrease the amount of payments related to the tax and eventually lead to lower total expenses.

3.3.Latvia has had long term taxation of sale of assets and treated it as sales of goods/services. Also today, the legal regulation in this respect is insufficient despite the fact that development and implementation of legislation in this area has commenced.

3.4. Without careful consideration and the required prior research, Latvia has implemented a regulation for determining the place of transaction by using the so-called rule of "use/enjoyment". During the first six months of 2006, legislation was amended in this respect two times, ranging from unlimited application of this norm to very limited possibilities to apply it. In both cases, this is not an optimum variant and many entrepreneurs moved their advertising services to neighbouring countries (especially Estonia) where regulation of this area is more stable.

3.5. Latvian tax payers are not allowed to adjust the amount of tax payable into the budget by the amount of bad debts, which imposes on entrepreneur's additional tax burden for unpaid transactions.

3.6. Latvia does not make full use of the rights granted to the Member States to apply the reduced VAT rate to certain transactions as set in the Sixth VAT Directive. Only Estonia, Latvia and Denmark apply the standard rate to all food products. Other Member States apply the respective reduced rate to food to a greater or lesser extent.

3.7. Latvia does not use the options provided by the Sixth VAT Directive to implement a more flexible VAT application in transactions with real estate which would permit selection of different tax regimes depending on the purpose of using the real estate or the status of the purchaser or the recipient of services, as well as allow the companies to chose options in VAT application in this area. As a result, the tax has lost its neutrality with respect to business activities and increases the expenses of taxable and non-taxable persons.

3.8. Latvia does not permit to defer VAT payments on goods import transactions except imports of fixed assets. At the same time, Latvia allows import of goods through Latvia to other EU Member States by using intermediaries and making no VAT payments on the border, which creates an unfair competition environment and promotes import of goods in Latvia through other EU Member States.

4. The European Commission is intensively working to further improve the tax system aiming at simplification, modernization and consistent application of the tax (in cross-border transactions), and at closer cooperation between the tax authorities of Member States in order to prevent economic crime. Latvia has opportunities to participate in this work and provide recommendations to promote the development of entrepreneurship in the country, reduce the administrative requirements in tax application, and ensure more effective work of tax administrations. These activities will result in significant changes in legislation in the years to come, which may initially cause problems with tax application in cross-border transactions.

5. Latvia applies extremely heavy and inflexible administrative procedures of tax application and formal non-compliance to them or failure to comply to the letter are often the basis for punishing the tax payer without consideration of the reasons for

non-compliance and the amount of loss incurred by the budget. The most problematic issues in tax administration procedures are the following:

- 5.1. The registration procedure of VAT taxable persons is too bureaucratic. Information and documents are asked that are already in the possession of state institutions, and review of the information received does not ensure that fictitious companies are identified and prevented from registration in the register of VAT taxable persons.
- 5.2. Exclusion from the VAT register is too often used as a penalty for committing insignificant administrative violations. This type of penalty is inadequate for the violation committed.
- 5.3. Latvia is the only EU member state which applies the registered way-bills invoices and way-bills bearing SRS issued authorised numbers. The way-bills issuance procedures, their usage, accounting and reporting is too bureaucratic, time-consuming and expensive, and is treated as an unnecessary administrative obstacle to entrepreneurship which does not reach to goal of implementing such way-bills, i.e. restrict illegal and unregistered entrepreneurship, and lessen tax evasion.
- 5.4. The Latvian tax penalty system is too severe and inadequate, and it does not encourage entrepreneurs to pay taxes. In addition, the norms of tax penalties are not consistent across legislation acts, and similar violations with respect to different taxes result in different penalty sanctions. At times, application of inadequate tax penalties lead to insolvency of a company, which does not promote development of business activities in the country.

Recommendations:

1. It is necessary to improve the Latvian normative acts on VAT application in order to eliminate contradictions with the norms incorporated in the Sixth VAT Directive, which would result in an improved and extended tax regulation and facilitated entrepreneurs' understanding of requirements in this area. To that end, there is a proposal to perform the following:

- 1.1. It is necessary to improve the Latvian normative acts by providing a special regulation on donations in order to promote charity without imposing additional tax burdens and administrative barriers on entrepreneurs. The Sixth VAT Directive provides for such an opportunity by allowing not applying tax to small gifts and placing no limits on deduction of input tax. Similar norms should be introduced in Latvia.
- 1.2. It is necessary to set in the legislation the moment of tax application and deduction of input tax in case an escrow account is used for payments. It would result in an elimination of different interpretations from tax administration and tax payers, and reduce the risk of surcharges due to an incomplete base of legislation.

1.3.The Latvian legislation should contain more precise definition and differentiation of regulations on deducting input tax on traveling, hotels, restaurants, use and maintenance of automobiles and residence expenses, etc. It is advisable to restrict the right for deduction of input tax with respect to purchase and maintenance of automobiles, except for cases when such automobiles are fully used in business activities, for example, taxis, cars purchased for lease purposes etc. This would permit to decrease the number of cases when input tax is deducted on automobiles that are fully or partially used for private purposes.

1.4.Legislation needs additional regulations on granting different discounts, making sales campaigns, granting bonuses, coupons, gift cards and other allowances. In practice, very different forms of allowances and client acquisition exist, and they do not have a consistent treatment in the legislation, which often results in disputes between the tax administration and tax payers.

2. It is necessary to promote adjustments to the Sixth VAT Directive in order to specify certain existing regulations and eliminate certain contradictions that cause problems in cross-border transactions including:

2.1.It is necessary to set the obligatory threshold for obtaining the status of a taxable person as the current threshold of EUR 5,000 is not observed practically in any member state. It would be advisable to increase in Latvia the obligatory registration threshold for VAT purposes from the current LVL 10,000 to LVL 45,000 which corresponds to the obligatory requirements set in other laws with respect to the application of the corporate income tax and submission of annual reports. At the same time, the option should be retained for persons to voluntarily register in the VAT payers' register irrespective of the amount of their transactions.

2.2.The Sixth VAT Directive should be complemented with a norm on determining the place of provision of management and marketing services to be determined by the legal address of the recipient.

2.3.It is necessary to ensure a consistent application of the obligatory provisions of the Sixth VAT Directive in all EU Member States by excluding the norms of the Directive that permit the application of special tax regimes in certain old EU Member States (EU-15), including resigning from the Sixth VAT Directive requirements with respect to relieves from VAT application and use of the reduced rate.

2.4.A new regulation should be developed in the Sixth VAT Directive with respect to VAT application to international passenger transportation services which would match the practical tax application in EU Member States and eliminate contradictions in the current regulations.

3. Latvia should assess and start introduction of the optional provisions allowed by the Sixth VAT Directive that would improve the business environment in the country resulting in improvement of the development of business activities. The most critical optional provisions of the Sixth VAT Directive that should be introduced, include the following:

3.1.A regulation should be incorporated in the legislation to allow persons who perform separate (occasional) taxable transactions to apply VAT to those transactions without becoming a permanent VAT taxable person. It would decrease the administrative requirements for such persons and ensure adequate tax application by preventing potential disturbances of competition in the country.

3.2.VAT grouping should be introduced in Latvia to decrease the burden of administrative duties for group companies, as well as to reduce the tax burden in intra-group companies. VAT grouping is advisable to use in developing public private partnerships on creation and development projects of various educational, health protection and social objects, to decrease the tax burden on such projects.

3.3.The Latvian legislation should be improved and developed in order to allow not applying VAT to sales of assets which would promote further development of business activities in the country.

3.4.Legislation should be improved by developing well-considered and reasonable regulation for determining the place of transaction by using the so-called rule of "use/enjoyment". This regulation should be applied not only to fixed telephone line services and lease of movable property, which is the current application, but also to services provided to non-taxable persons of third countries who do not perform business activities, as well as to use/lease services of commercial vehicles, including railway wagons.

3.5.It is necessary to introduce the possibility for tax payers to adjust the amount of VAT payable to the budget by the amount of bad debts and determine the entrepreneur's liabilities in bad debt collection.

3.6.It is necessary to assess a gradual introduction of the reduced VAT rate of 5% to food, by starting introducing this rate to certain most common food products in Latvia and gradually extending the application of this rate, in order to avoid from rapid decrease in the budget revenue and to ensure lesser tax impact on the prices of food.

3.7.A more flexible approach should be introduced in VAT application to transactions with real estate, with an option of tax exemption on real estate used for social, health protection, cultural and educational purposes, or for private consumption purchased by non-taxable persons, at the same time allowing tax application on sales of used real estate used only for taxable transactions. Also, under certain conditions it should be allowed to let tax payers chose a tax regime.

3.8. Possibilities should be extended to defer VAT payments for imported goods made on the border, determining that this tax be included in the tax return for the taxation period. It would improve cash flow in companies and promote the development of logistics services in Latvia.

4. Further development of the normative base of this tax on the EU level should be aimed at simplifying the application, modernizing and aiding consistent understanding. To that end, work should be done in the following directions:

4.1. It is necessary to introduce the so-called "one-stop scheme", which would create opportunities for entrepreneurs who perform business activities in several countries, to perform administrative functions (including registration for VAT purposes, reporting etc.) in one country, where this company is registered (country of residence). Tax payments on transactions performed in a concrete Member State would be made in the bank account of that country.

4.2. It is necessary to simplify and accelerate the refund of VAT paid in another Member State which is possible by ensuring that documents have to be submitted to the tax administration of the tax payer's own country, and which requires consistent determining of input tax in all Member States and closer cooperation among tax administrations of Member States. It would result not only in reduced administrative requirements for tax payers but also in improved quality of review of submitted documents ensuring that tax amounts are appropriate for the specifics of the transactions performed.

4.3. In order to simplify tax administration in transactions between Member States it is necessary to extend the application of the reverse charge system, which would decrease the necessity to register for VAT purposes in several Member States at the same time.

4.4. An alternative solution to the reverse charge system is the proposal to introduce the so-called "common tax" for transactions between Member States, which would eliminate the unequal tax payment procedures in inland and cross-border transactions, and eliminate the opportunities to evade tax payments, and the preference to disclose as the transaction partner a company registered abroad, and significantly reduce the administrative requirements both for the tax payer and tax administration.

5. It is necessary to make crucial changes in the attitude towards setting and applying administrative requirements in the country by assessing the efficiency, reasonableness and meaning of each requirement in tax application and administration. At the same time, it is necessary to develop a completely new tax penalty system in Latvia, in order to decrease the amounts, determine the adequacy of the tax penalty applied compared with the violation committed, and create a common and harmonized penalty system for all taxes, and set homogeneous penalties for equivalent violations in the application of different tax types.