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# CAPITAL GAINS TAX IN LATVIA AND EUROPEAN UNION

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## Introduction

Recent developments in Latvia as a result of government plans for reducing inflation and stabilizing economy has affected taxation system in Latvia and among other things introduced personal income tax on sale of shares of real estate companies. The government has been continually expressing various ideas on the potential taxation of gains on the sale of stocks and real estate. Gains on the sale of stocks and real estate should be treated as capital gains and hence there arises a topical question if there would be necessary to introduce in Latvia a new capital gains tax and what potential tax consequences could be. However, the final decision regarding introduction of new type of tax has not been made yet. In addition, the fact that in most of the EU Member States capital gains are subject to tax brings out the necessity to analyse this tax on the local level and discuss the perspectives of its introduction in Latvia. Although this issue is being dealt with by the government, there is not enough detailed information about the impact the tax might cause on the Latvian entrepreneurial environment, state budget, and overall prosperity of the country.

***The aim of article***. The aim of this article is to evaluate whether capital gains tax on sale of real estate and stocks should be adopted in Latvia and whether it would have effect on inflation level and economic development in Latvia.

***Research objectives.*** Research objectives of this article are to review current taxation system in Latvia in relation to capital gains, taking into account recent changes in tax legislation as a result of government plan to combat inflation. Data from other Member States of European Union will be analysed to compare how Latvian tax system compares to tax systems in other Member States in the area of capital gains taxation.

***Research methods.*** Research methods of this article will be summarizing information about capital gains tax in other European Union Member States as well as comparing this information to determine whether Latvia would benefit from using the experience of other countries in this regard. This will be achieved by reviewing the trends of real estate gains as well as sale of stocks taxation in various European countries and comparing these trends.

***Research results.*** This article will seek to analyse the essence of the term 'capital gains', practical problems related to the application of capital gains tax, pros and cons of introducing this tax in Latvia, newly accepted provisions of the Law on Personal Income Tax governing the sale of stocks in real estate companies, as well as newly accepted provisions of the Law on Corporate Income Tax on the application of tax to sale of stocks in real estate companies.

## Challenges of capital gains taxation

To begin with, it is necessary to assess whether such kind of gains should be taxable in Latvia and whether the state will derive additional income after the introduction of this tax compared to administrative expenses which would arise due to the necessity to control tax calculation and payment. Capital taxation might bring about certain problems. First, the impact of inflation on capital gains should be taken into consideration, as capital gains may grow also in the result of being influenced by inflation. In this case both real gains and inflation (monetary) gains are subject to tax. Therefore, the amount of money paid upon the acquisition of the asset cannot be objectively compared to that obtained in the result of its sale. It should be noted that inflation enhances more rapid growth of nominal asset gains than that of nominal wage gains. As a result, the equal growth of nominal gains derived from both of the above sources reflects the unequal growth of real purchasing power and hence the equal tax burden causes unequal treatment. The tax base grows, as the expected inflation produces a twofold impact on capital gains: both the asset value and the asset gain rate are increased. To define taxable capital gains, the taxpayer would have to increase the acquisition price by the accrued inflation factor prior to it being deducted from the present value. Due to inflation, fixed-income securities as well are losing their value in real terms each year, and the original amount of investments might also diminish (Harvey S. Rosen, 2002). This problem is particularly burning in Latvia, as currently inflation is running rather high which means that, prior to imposing capital gains tax, it should be carefully considered how the inflation factor will be taken into account to prevent a situation where not only real gains but also inflation gains are taxed.

The given inflation adjustments are true only where inflation is always fully foreseeable and all gains, being affected by inflation, grow at the same pace. In reality, neither of these conditions is met. Therefore, upon making adjustments, it would be more practicable for the governments to use real inflation rates rather than expected rates. The economic research still has not defined how expected inflation is formed. Regardless of the above, nominal interest rates and capital values almost definitely adapt to expected inflation, partly at least. Therefore it would be more appropriate to peg capital gains to a long time mean inflation index rather than make any adjustments at all. Those who fail to forecast inflation correctly might face unexpected profits or losses compared to the theoretical model, but it could be hardly avoided. Practical is the question about what long time series should be used, as assets and other sources of income have different rates of inflation. In fact, the consumer price index could be relevant, although it is not a perfect solution here (Arnold C. Harberger, Martin I. Bailey, 1969).

Second, it would be necessary to assess what should be subject to capital gains tax: total accrued capital gains or only realised capital gains. If capital gains would be taxed as soon as they arise (not realised), there might emerge certain difficulties in determining the amount of the capital increase. There are assets for which the increase in the value is hard to determine, since they are not traded regularly and actively. For instance, antiquities, paintings, and real estate. In addition, capital gains may be derived irregularly, which renders the tax administration process even more complicated. In practice, realised capital gains are taxed, but the procedure for taxation of realised capital gains has several deficiencies. In this case, capital gains tax is deferred until capital gains are realised. This possibility of deferring taxes may seem insignificant, however consequences may be rather serious, as in fact the private individual obtains a perpetual interest-free loan from the state, and only tax is paid after capital gains have been finally realised.

As the comparison of tax payable after the realisation of capital gains and tax payable also on unrealised capital gains over a certain time period shows, the post-tax capital gains are larger where realised capital gains are used as the tax basis. The reason for such difference is that deferment of tax payment permits the investment to grow in geometric progression based on the pre-tax rather than post-tax rate. Since only realised capital gains are subject to tax, taxpayers intending to hold or sell assets should take into consideration that tax shall be payable upon the sale of assets, and for this reason taxpayers might prefer to keep to the same kinds of investments (Harvey S. Rosen, 2002).

The introduction of capital gains tax or the reduction of tax rates is rather a controversial issue, as the tax has both positive and negative aspects. In their essence, capital gains are income and therefore would be subject to tax in the same manner as salaries. In addition, as the data evidence, income is basically concentrated in the hands of high-income taxpayers. More than half of the aggregate capital gains is realised by the best-off 1% of taxpayers, and they are those benefiting from the low tax rates or the absence of capital gains tax (Slemrod J., 1996). It is unfair from the social viewpoint. In the absence of capital gains tax, taxpayers are tempted into using existing possibilities of transforming their income into capital gains, and this is the reason for aggressive tax planning and the state budget losing potential tax revenue. Moreover, only the wealthiest part of the community can enjoy this possibility. Capital gains tax reduces investments in non-productive assets, like antiquities, coins, paintings, or stamp collections acquired for generating a profit from the increase in the value, while in fact bringing no added value (James S., Nobes Ch., 1997).

It should be admitted however that the introduction of capital gains tax might hinder capital formation and restrict investing, which would entail hampering of further business development, productivity growth, economic development, and reaching higher living standards, while prudent taxation of capital gains would stimulate capital accumulation and risk taking. Furthermore, capital gains tax applied only to realised gains causes economic failure. Capital is frozen and prevented from flowing to more profitable investments. The data show that accrued capital gains on more than half of stocks are not realised for several years in order to defer tax payments. Both well-off and moderately well-off taxpayers put certain limits on realisation of their capital gains. Thus revenue the state derives from capital tax is rather small (Arnold C. Harberger, Martin I. Bailey, 1969).

The administration of capital gains tax collection is rather complicated for reason of the aforementioned tax application problems. Hence the imposition of capital gains tax might require substantial tax administration costs. It is believed that it would be fair not to tax capital gains since these are irregular and may arise unexpectedly. In addition, investing means refraining from consumption, which may be compensated by non-taxation of capital gains. This reason is, however, not strong enough since the opponents of this opinion might claim that the treatment of labour income might be less strict in the same way since this kind of income includes unpleasant work conditions or dislike of work, while after investing all we have to do is wait for money to come. Therefore it cannot be stated with absolute certainty which of the sources of income (labour income or income from capital investments) would be more appropriate to tax (Harvey S. Rosen, 2002).

**Current laws and prospects of the imposition of capital gains tax in Latvia**

Currently no capital gains tax as such exists in Latvia. Part of this tax functions are ensured by the provisions included in the Laws on Corporate Income Tax and on Personal Income Tax. Passive income includes gain on the sale of real estate, gain on the sale of securities, interest income, and dividend income. According to the Law on Corporate Income Tax, gains on the sale of real estate and securities, and interest income are subject to corporate income tax. Local companies thus pay corporate income tax instead of capital gains tax. As regards private individuals as taxpayers, the provisions of the Law on Personal Income Tax envisage that in Latvia tax shall not be imposed on income from the sale of own property, with an exception of several specific items. It should be stressed that although it is not directly envisaged in the Law on Personal Income Tax, however, according to the clause mentioned regarding sale of own property, gain from the sale of securities (with an exception of stock in companies holding real estate in Latvia) also shall not be subject to tax. In addition, it is also laid down in the Law that income from deposits with credit institutions and savings-and-loan associations registered in the Republic of Latvia and other EU Member States, as well as income from mortgage bonds shall not be subject to personal income tax. No tax shall be imposed also on income from bonds of the government and municipalities of Latvia. No personal income tax shall be imposed on dividends paid out to private individuals from the profits of a Latvian company or capital company and profits of a capital company resident in an EU Member State, except dividends from foreign non-residents and domestic undertakings which are not required to pay corporate income tax, as well as those undertakings which enjoy tax reliefs provided for by the Law on Foreign Investments in the Republic of Latvia or tax reliefs specified in other Latvian laws, or analogous corporate income tax reliefs fixed in the EU Member States in the year when dividends are declared or in the preceding year.

Previously legislation provided for exemption from personal income tax on sales proceeds from sale of real estate which has been in the possession of the individual for longer that 12 months period. This meant that profits from real estate transactions were virtually tax free. In the beginning of May 2006 the Ministry of Finance suggested introducing capital gains tax on income from speculative real estate transactions to compensate for the decrease in tax revenue after the projected tax reform. These suggestions were not accepted until the government took a stand regarding combating inflation and on 17 May, 2007 supported various changes in the Law On Personal Income Tax and Law On Corporate Income Tax, which were published in “Latvijas Vēstnesis” on 29 May and came in force on 12 June, 2007. These changes among other also impact sale of stocks in companies which own real estate in Latvia. The Law On Personal Income Tax has been amended and significant changes refer resident’s and non-resident’s income generated from real estate located in Latvia which will further comprise income from disposal of shares/ stocks or other investments in domestic or foreign capital companies or other persons (within the meaning of the Corporate Income Tax Law) provided that in the year of such disposal or in the previous year real estate located in Latvia represents or represented more than 50 per cent of such person’s assets, directly or indirectly (via investments in one or several other persons incorporated in Latvia or any other foreign country).

The amendments provide for the deletion of the clause which set forth that no tax would be charged on income from sale of real estate which had been owned by the person for more than 12 months. The Law is supplemented with a clause whereby no tax will be imposed on disposal of such real estate which has been owned by the payer for more than 60 months (from the date that the estate is registered with the Land Registry) and has been the declared place of residence of that person (other than the additional address) for at least twelve months prior to signing of a respective agreement on disposal. Income from transactions aimed at disposing of the rights to acquire real estate will be also deemed to be income from real estate disposal.

The Law specifically establishes the procedure for defining income from disposal of real estate used in business operations or reclassification of such estate to an item intended for personal needs. The Law is supplemented with a section laying down special provisions for defining income from disposal of agricultural companies and agricultural land.

Also Law On Corporate Income Tax has been amended this year and the provisions related to income derived by non-residents in Latvia have been amended to further provide that, in respect of non-residents, tax at 2 per cent will be deducted also from income generated from disposal of shares/ stocks or other investments in domestic or foreign companies or other persons provided that in the taxation period of such disposal or in the previous period real estate located in Latvia represents or represented more than

50 per cent of such person's assets, directly or indirectly (via investments in one or several other persons incorporated in Latvia or any other foreign country). It should be noted that this provision does not apply to income generated from disposal of publicly listed securities of the European Union or the European Economic Area.

Above mentioned rules clearly create uneven taxation system for stocks as stocks of companies owning real estate become taxable while other company stocks are tax-free for private persons. This could result in stagnation in some industries which require fixed assets in the form of real estate, such as manufacturing, and development of industries which do not require ownership of real estate. Therefore, it is suggestible to consider applying the same tax treatment to all sales of stocks regardless of assets the company possess.

**Taxation of capital gains in the Member States**

Since at corporate level in Latvia gains from the sale of real estate and stocks are subject to corporate income tax and no changes are expected in this area in the foreseeable future, we will discuss the tax treatment in the event of the sale of real estate or stocks owned by private individuals. This section will deal with income tax rates applied in the Member States to these kinds of transactions and tax exemptions envisaged by the European laws and regulations to prevent the taxation regime from being unfair from the social standpoint. Information has been compiled by reviewing capital gains tax laws in various countries.

In the European Union, the tax treatment of gains on the sale of real estate and stocks varies from country to country. It should be noted, however, that the majority of the Member States have chosen to tax capital gains on the sale of real estate and stocks. For the most part, gains on the sale of real estate or stocks are subject to personal income tax at a progressive rate depending on the amount of gains obtained. Therefore, the larger is the individual's income, the higher tax rate is applied. In the table below are presented personal income tax rates applied in the Member States to gains derived by private individuals on the sale of real estate (EYGM Limited., 2006).

Table 1

**Personal income tax rates prevailing in the EU Member States which apply personal income tax from gains on the sale of real estate**

| Country | Personal income tax | | |
|---|---|---|---|
| | Intervals | Minimal rate | Maximum rate |
| Germany | 8 | 15 | 42 |
| Italy | 4 | 23 | 43 |
| Great Britain | 3 | 10 | 40 |
| Belgium | 5 | 25 | 50 |
| Austria | 3 | (Income – €10,000x5,750) / 15 000 | Income – €51,000x0,5 + €17,085 |
| Denmark | 4 | 15 | 32 |
| Czech Republic | 4 | 15 | 32 |
| Slovakia | 1 | 19 | 19 |
| Lithuania | 1 | 15 | 15 |
| Estonia | 1 | 24 | 24 |
| Slovenia | 5 | 16 | 50 |
| Malta | 6 | 0 | 35 |

Source: EYGM Limited., 2006 data and review of taxation systems of various countries

In several Member States (Denmark, Great Britain, Luxembourg, Czech Republic, Slovakia, Estonia, and Malta) these gains are subject to personal income tax at the same rates as applied in respect of other kinds of personal income. Moreover, each of the aforementioned states has certain departures from the general principles of capital gains tax. For instance, in Denmark the maximum permitted personal income tax rate that may be applied to gains from the sale of stocks, which have been held by one person for more than three years, is 43%. In Luxembourg and the Czech Republic capital gains from the sale of stocks are subject to personal income tax only where stocks are sold earlier than six months after acquisition. In Estonia personal income tax is applied only to stocks of those companies which, according to their balance sheets for the prior financial year, have reported real estate located in Estonia of more than 75% of their aggregate assets. In Great Britain there is contemplated an exemption from personal income tax for capital gains from the sale of stocks having the maximal value of GBP 8,200, while in Italy, Spain, and Austria such capital gains are subject to tax either at personal income tax rates or, where specific criteria are met, at lower rates. For instance, in Italy the reduced tax rate (12.5%) is applied to capital gains related to shareholding not exceeding 2% of the voting rights or 5% of the subscribed capital in case of listed stocks, or 20% of the voting rights or 25% of the subscribed capital in case of non-listed stocks. In Spain capital gains from the sale of stocks are subject to income tax at 15% if such stocks have been owned by one person for more than one year. In Austria partial exemption from income tax is applied where the owner has had 1% or more of the shareholding during five years prior to the sale. If this would be the case, it is possible to benefit from a 50% discount from the standard tax rate. In Lithuania and Belgium this kind of gains is not subject to tax except where at least 25% of stocks of a Belgian company are sold to non-residents. Tax rates applied in other Member States to gains from the sale of stocks are summarised in the table below (7).

Table 2

**Personal income tax rates applied to gains on the sale of stocks in EU Member States**

| Country | Tax rate (%) |
|---|---|
| Germany | 50% of the standard rate of personal income tax |
| France | 27 |
| Netherlands | 25 |
| Greece | 5 |
| Portugal | 10 |
| Sweden | 30 |
| Finland | 28 |
| Ireland | 20 |
| Poland | 19 |
| Hungary | 25 |
| Slovenia | 25 |
| Cyprus | 20 |

Source: EYGM Limited., 2006 data and review of taxation systems of various countries

In some of the aforementioned Member States, several tax exemptions are envisaged. For instance, in Germany such an exception applies where stocks have been held by one person for more than 12 months and constitute less than 1% of the aggregate capital. In Portugal capital gains from the sale of stocks are not taxed as well if stocks have been owned by one person for more than 12 months. In the Netherlands it is possible to benefit from tax exemption where stocks owned by a private individual represent less than 5% of the aggregate capital. In France no tax is applied to capital gains on the sale of stocks amounting to less than EUR 15,000. In Slovenia only 40% of gains on the sale of stocks sold within three years after their acquisition are subject to tax. In Cyprus, like in Estonia, tax is applied only to gains on the sale of stocks of those companies which have real estate in their assets.

In brief, the common practice in the Member States is to tax capital gains on the sale of stocks either at personal income tax rates or at reduced tax rates. In addition, where stocks are held for a period longer than fixed in each respective Member State, the respective capital gains are tax-exempt or subject to tax at lower rates. The applicable tax rates also depend on the proportion of the stocks sold in the aggregate capital.

## Conclusions

From above analysis can it be concluded that:

- The fact that in Latvia capital gains from the sale of real estate companies are subject to taxation and capital gains from the sale of other shares and stocks are exempt from personal income tax provides uneven playing field for entrepreneurs;
- It would be advisable to even out these differences in tax treatment of various stocks and introduce one taxation system, which would provide for the same tax treatment of sale of shares in companies, regardless of the type of assets company uses for its business activities.
- Considering the European experience, it would be suggestible to consider implementing lower rate for capital gains tax on sale of stocks, rather than maintain current 25 percent rate of personal income tax.

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**Kapitalo pajamų mokestis Latvijoje ir Europos Sąjungoje**

Santrauka

Straipsnyje nagrinėjami pastarojo meto potencialūs pokyčiai Latvijos mokesčių sistemoje, galimybė įvesti kapitalo pajamų mokestį pelnui iš nekilnojamojo turto ir akcijų pardavimo. Pelną iš nekilnojamojo turto ir akcijų pardavimo reikėtų laikyti kapitalo pajamomis, todėl kyla klausimai, ar reikalinga Latvijoje įvesti naują kapitalo pajamų mokestį, kokios būtų potencialios mokesčio pasekmės. Be to, nagrinėjamas poveikis infliacijai, taip pat keliamas klausimas, ar apmokestinti padidėjusias ar tik gautąsias kapitalo pajamas. Straipsnyje pateikiami argumentai „už" ir „prieš" dėl kapitalo pajamų apmokestinimo įvedimo Latvijoje, analizuojamas jo poveikis ekonomikos vystymuisi. Straipsnyje siūlomi Latvijos mokesčių įstatymų pakeitimas – apmokestinti bendrovių akcijas. Pranešime lyginamas ir analizuojamas kapitalo pajamų apmokestinimas kitose Europos Sąjungos šalyse narėse ir aptariama šių skirtingų šalių patirtis šioje srityje.

**Pagrindiniai žodžiai**: kapitalo pajamos, nekilnojamasis turtas, akcijos, apmokestinimas.