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Can one pack its business in a suitcase and carry away (to pay less taxes)?

A translation of Edgars Koskins' Forbes Latvia article.

We can choose a spouse, but not our motherland: it should be loved just the way it is. Other possibilities are to attempt coping with it or just "spit" on everything and organize a farewell party. It sounds as a relatively easy choice if there is not much left behind. If the main motives for such a step are complaints about unpredictable tax policy, high labor tax rates, corruption, bureaucracy etc., it sounds more like coming from a person facing the option to leave its business. What can be heard then (periodically) are affirmations that a business can be transferred to another country in order to avoid paying "unbearable Latvian taxes". The objective of this article is to consider in a calm and logical manner whether it is possible to pack ones business in a suitcase next to your toothbrush and take it to another country with the aim of paying less tax there?

All over the world the business activity can be divided into three main categories: production, services and trade. **Let's start with PRODUCTION** and the fact that registering the company abroad or carrying out any other similar activities won't allow a local production unit and its workers pay less tax. Let's imagine a meteorite processing plant in Salacgriva that gets raw material in the famous meteor crater and labor force which consists of locals coming back to the city to stay overnight. It is a typical example where a company and its workers remain the Latvian tax residents and pay the income and social taxes in Latvia. Basically tax systems are designed according to the same principle: a business activity carried out in a certain country is subject to the tax system of that country. Therefore it is more likely an illusion and not a reality that a local business can be all of a sudden registered in another country with low or zero taxes. Technically it can be done, but it would not give the expected result as the local tax burden will remain the same. Cross-border mergers don't change the situation fundamentally either, as the meteorite is still being processed locally and no fundamental changes have occurred. In this case we can speak of a possible global benefit for an international group of companies and the reduction of the overall corporate income tax burden, but the salaries of local workers, real estate etc. will still be subject to the domestic tax.

A more realistic scenario is leaving the country for real. Such a solution is not an easy one, but is quite common on a global scale. For example, a textile company dismisses its workers, loads all production equipment on board and starts all over in another country, let's say: in Pakistan. Then, as our beloved poet Rainis would say, the song of a factory girl is being sung in another language in another land. Such a situation allows for the expected result, i.e., not having to pay the Latvian tax but only because the business itself is not in Latvia anymore.

Something in between staying and leaving Latvia happens if structural changes to the promotion of production and sales are being made. For example, the rejection of the classical approach, when the production assets, raw material, production process itself and the final producs is owned by one company in one country. Instead of that a foreign business for ordering and distributing products can be introduced, while the local business would only have to take care of the production. Such an approach gives an economic justification for leaving a considerable part of the production income in a country in which the income is subject to a lower income tax. A hypothetical example: a Latvian entrepreneur Buck successfully produces homeopathic medicinal products (*LatCo*). Realizing the success of his product, Buck decides to quickly introduce a new panacea that would be sold out with high profit margins. Let's assume that Buck' financial resources have been accumulated in recently so widely criticized offshore companies, for example, in a company registered in the Bermud Islands (*BerCo*).

Since Buck considers the Latvian government to be unfair with the entrepreneurs, he decides to establish the basis for the ideological development and promotion of the *panacea* in another country in which the tax policy is more favorable, for example, in Malta. Through *BerCo* Buck establishes a company in Malta (*MalCo*). The director of *MalCo* is Penny, director of one of Buck' former companies in Latvia, who used to receive the gross remuneration of EUR 150 000. Penny' future remuneration package is as follows: his duties no longer are in connection with the local business in Latvia. The guaranteed remuneration of the panacea project would amount to EUR 150 000, for which Penny is entitled to issue an invoice from another offshore company, for example, the Panama company (*PanCo*). (Penny doesn't rely on the state provided pension after reading the essay of Roberts Kilis on poverty benefits instead of pensions.) In order to manage the finances in an easier and more confidential way, Penny establishes a company in Cyprus (*CypCo*), which will be a 100% owner of *PanCo* – the company established in Panama.

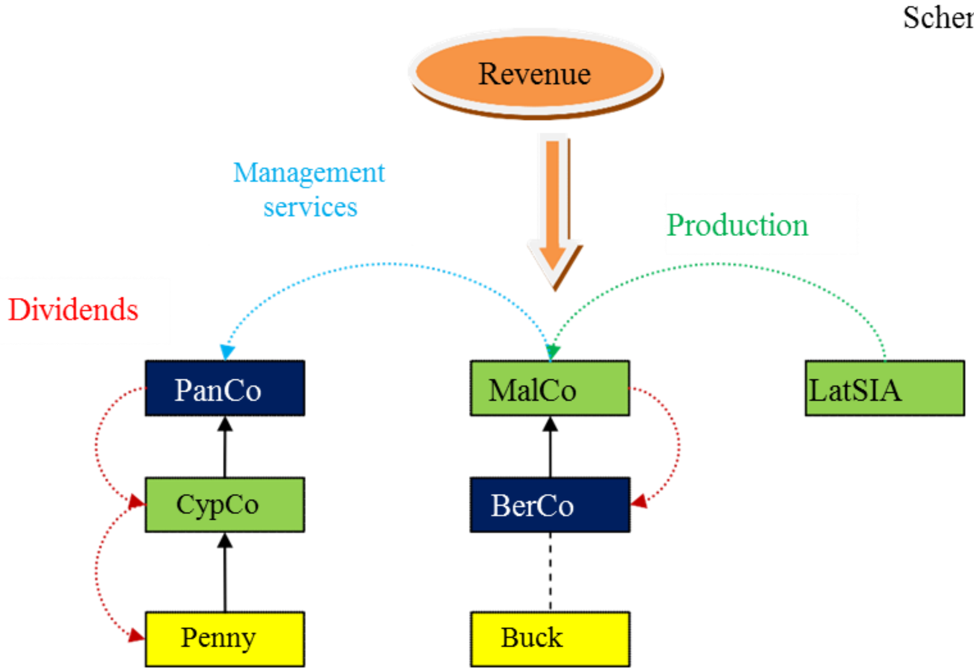
The marvelous business plan allows targeting a substantial profit of two million euros. Also *LatCo* production capacity will produce enough quantity of the new product. Moreover, *LatCo* will gain a profit margin of only 3-5% as it won't be the owner of the raw material, won't be subject to the risk of product sales, won't perform any marketing, etc. Those will be *MalCo's* responsibilities and *LatCo* will only produce the orders. Finally, it should be assumed that everything is about to work out and conclusions on tax efficiency should be made (Scheme 1).

First comes the corporate income tax (**CIT**) and its payment. After distributing the profit, the effective tax rate will be 5% in Malta and 15% in Latvia. Consequently, CIT from two million euros in Malta will be 100 000, which is EUR 200 000 less than it would be in Latvia. In reality this sum could be even smaller, if *MalCo* would deduct interest rates, trademark fees etc.

Then comes Penny' personal remuneration and its taxation. If it was a previous salary arrangement where Penny was paid in Latvia, Penny from the salary of EUR 150 000 would receive the net amount of approximately EUR 100 125. Moreover, Penny would cost to Buck an additional sum of money in the amount of EUR 36 135 as the Employer's social security payments. As a result the total salary costs would be approximately EUR 186 135. But that can be considered to be Penny's and the state budget's history. Penny spends approximately 4-5 thousands of euros in order to maintain his foreign companies. Then *PanCo* issues an invoice for management services to *MalCo* and all the money in the amount of EUR 150 000 goes to *PanCo* which doesn't pay any tax at all. *PanCo* transfers dividends to *CypCo* and *CypCo* pays them out to Penny. There will be no tax consequences in Cyprus, but in Latvia the personal income tax (**PIT**) to pay be paid will be 10%. Penny gains the net amount of approximately EUR 130 000. If everything has been calculated the right way, Penny gets additional EUR 30 000 to invest in a private pension fund. Buck is happy as well as he has saved EUR 36 135 as he does not have to contribute to the Penny's social security payments.

In general this is a relatively safe mechanism which, of course, faces some problematic issues, for example, the market price between related companies, permanent establishment in Latvia and other possible risks.

Scheme 1



SERVICES. If the nature of services is doing laundry for Riga's bankers, it doesn't differ much from the aforesaid about production. Local business means local tax consequences. If a similar activity would take place in Valka (the Latvian part of the town which is divided by a joint border), it could be an option to establish a company in Estonia and to operate in Valga (the Estonian part).

A good example for difficulties and solutions of tax planning in the services sector is accounting services, the main and only problem of which is the fact that the local accountants are the main production assets. It would be tempting for a big company to receive an invoice from a tropical country for services provided by hardworking subcontractors. In fact, it would be very hard to prove that someone so far away is really able to provide real help to Latvian companies. The story would be different if a group of accountants went away and started a life under palm trees and submitted the electronic tax declarations from there. Then the trick of low tax rate would really work out. It has actually happened in the real life, though not in the palm–tree-lands though, but between the Nordic and Baltic countries when carrying out accounting training and teaching a foreign language to Latvian accountants allows them to serve foreign businesses. However, it should be admitted that usually the leitmotif is the low local salaries and not the low tax rate.

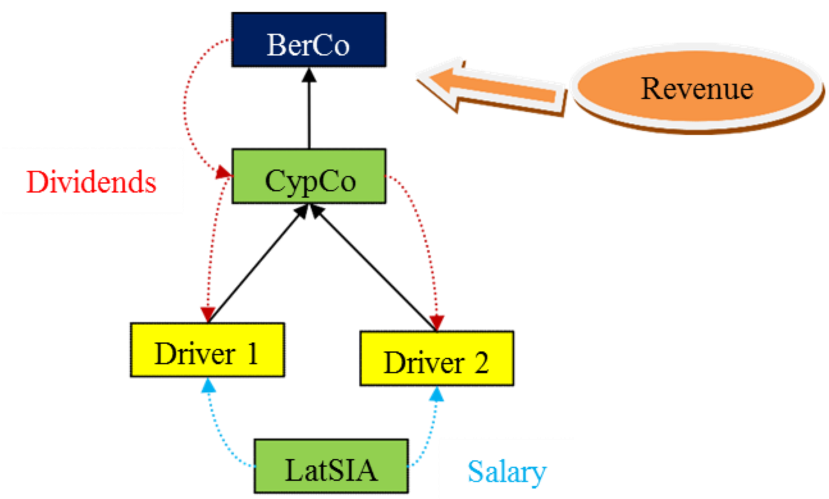
However, those, whose services are not so geographically restricted, may think of "leaving" the country, but actually staying where they are. For example, the internet business. Internet is so volatile, that it is problematic to say where it is actually based. Software can be also sold from a server in the Bermuda Islands as well. The electronic payment services can be provided via companies in foreign jurisdictions as well. Transactions carried out on an international level are not a rarity, and an outsider can't really tell where the owners of those structures are actually based. A tax theory might be equipped with different concepts that will always provide some tools to a high or relatively high tax jurisdiction to gain its share of income, but careful planning can bring significant results. Internet, of course, is a relatively simple example. Let's imagine now that the aforementioned Buck has established a logistic company (*LatCo*) that successfully operates in the Western Russia and Belarus. The drivers are Latvian tax residents and usually come back home – to the *LatCo* base - at the end of the trip. The fact that Russian and Belorussian customers are eager to the use of offshore companies makes Buck to consider using a tax optimization scheme.

Buck uses its company based in the Bermuda Islands (*BerCo*) in order to receive a part of money from the customer companies registered in tax havens. Meanwhile *BerCo* is owned by the company in Cyprus (*CypCo*). This is when the most interesting part of the story starts. The drivers acquire *CypCo* shares and become owners of this company. Let's imagine each driver receiving dividends in the amount of LVL 1000. Easily understandable tax consequences: PIT rate of 10% (LVL 100) applies to dividends declared by the drivers. They get LVL 900 after taxes. If a driver got paid a salary in the amount of LVL 1 000, the remaining amount of money after taxes would be LVL 667 (effectively more than LVL 200 are paid in taxes). Moreover, the approximate costs for *LatCo* as an employer would be LVL 1 241. Therefore, the total tax burden is approximately LVL 574. If there are 100 drivers, two tax burdens in comparison look like this: 10 000 against

57 400. The approximate maintenance costs for foreign companies would be 4 – 5 thousand euros. Thus, it is paying off.

The scheme in overall is tempting but quite dangerous At least one significant question arises here: shouldn't an income requalification be carried out, i.e., should it be considered that this situation deals with a disguised payroll?

Scheme 2



And finally: **TRADE**. In terms of a gas station or a grocery store chain, the aforesaid should be repeated again: local business means local tax. Localization loses its importance if a trade requiring no significant assets and involving several countries is carried out. Many Latvian entrepreneurs still believe in the old idea of selling goods produced in Latvia to its own offshore companies and leaving the income in the tax free zone. I won't go deeper into exploring this idea, but I will only remind that this scheme is brilliant until the moment the tax inspection starts asking questions. However, the main problem in this mechanism is the lack of economic substance. To be more precise: an entrepreneur is selling goods to himself and is complaining about low income locally. By improving the trading company's independence and by refreshing its economic substance, a relatively easy mechanism that allows for selling and saving at the expense of local tax can be developed.

In conclusion I would like to mention two things. First of all, if your business is based in Latvia, the tax costs remain there as well. Therefore this business must be uprooted and replanted elsewhere or other solutions should be looked for. The business can be looked at from different perspectives and angles in order to understand, if the idea of moving to another country is the only possible option. Usually there is more than one option. Everything depends on the scope and nature of the business. Second, a Finnish entrepreneur after years of success in Latvia once said to me: "I don't understand the Latvian businessmen who put so much effort in finding a possibility to pay less tax. Why not to comply with the general rules of the game?! They should better spend the same energy into developing new business ideas.” All I could answer to that was: ”I guess it is simply written in our genome”.