

Taxation of permanent establishments under new CIT Act (3/16/18)

This article describes the rules for taxing a permanent establishment (PE) in Latvia under the new Corporate Income Tax (CIT) Act effective from 1 January 2018. The new CIT regime is based on the taxation of distributed profits, while retained earnings are not taxed. This raises the question of what is a profit distribution in a non-resident company's PE or branch since they cannot pay dividends.

The rules for calculating the CIT liability of a non-resident's PE in Latvia are laid down by the CIT Act and the Cabinet of Ministers' Regulation No. 677, *Applying provisions of the Corporate Income Tax Act*. Below we present an overview of what constitutes the taxable base for a PE in Latvia from 1 January 2018. Please note that PEs and branches are similar structures for tax purposes.

What to tax?

As with companies, a PE's taxable base is a sum of taxable items consisting of profit distributions and deemed distributions. However, the PE's taxable base consists not only of taxable items incurred directly through the PE but also of any taxable items the non-resident allocates to the PE. Since technically branches and PEs cannot pay dividends, this fact makes it more difficult to determine what forms the taxable base for a PE or branch.

Profit distributions and deemed distributions

As described in our series of MindLink articles about the CIT reform, taxable items are as follows:

Profit distributions	Deemed distributions
<ul style="list-style-type: none"> • Declared dividends, including interim dividends; • Deemed dividends (any portion of profit being added to share capital of the company or PE owner), including any surplus assets on winding-up; and • Payments treated as dividends (a cooperative society's profit payments to its members, a sole trader's profit distributions, a partnership's profit share-outs, and certain payments a PE makes to the non-resident*). <p><i>*Payments treated as dividends include any payments the PE makes to its non-resident owner that are not considered the non-resident's expenses for ensuring the PE's operations.</i></p>	<ul style="list-style-type: none"> • Non-business expenses • Fines/penalties • Excess costs incurred on so-called representation and staff sustainability events • Donations • Transfer pricing adjustments • Loans to related parties • Doubtful debts • Excess interest payments • Benefits a non-resident allocates to its employees or board members, regardless of the recipient, if such are allocated to a PE in Latvia

Non-business expenses, excess representation costs and fines/penalties should be included in the taxable base each month. Other expenses to be recognised as deemed distributions, such as transfer pricing adjustments and excess interest payments, should be included in the taxable base for the last tax period of the financial year.

Payments treated as dividends for the PE

The PE's taxable base includes items in cash or otherwise that are extracted from the PE, including profit distributions and deemed distributions, under section 4(13) of the CIT Act. These items include the following under paragraph 23 of the Cabinet Regulation:

- Any payments to the non-resident exceeding 10% of expenses not related to the PE's business (e.g. expenses not listed in paragraphs 22 or 25 of the Cabinet Regulation);* and
- The non-resident's direct revenue gained through and allocated to the PE.

*The following expenses would be excluded from the PE's taxable base:

- Cost of goods sold (COGS) the PE pays to the non-resident for goods supplied for resale (as if they were acquired by an independent company from an intermediary but not the final reseller) are considered business expenses and excluded from the taxable base under paragraph 25 of the Cabinet Regulation;
- Up to 10% of non-business expenses incurred to cover the non-resident's general and operating expenses relating to the PE's operations supported by documentary evidence, other than the cost of goods acquired for resale mentioned above, are not considered items extracted from the PE under paragraph 24 of the Cabinet Regulation;
- The PE can deduct from its profits for CIT purposes any business expenses actually incurred by the non-resident, supported by documentary evidence and capable of being allocated to the PE under paragraph 22 of the Cabinet Regulation.

Accordingly, the PE's taxable profit is significantly affected by keeping separate books and holding documentary evidence for the type of expenditure concerned (COGS, expenses related to the PE's business activity, or non-business expenses).

In our coming articles we'll be exploring the practical implications of allocating profits to the PE, including the timing of such allocation and ways of organising the PE's bank accounts.