

# Taxation of permanent establishments under new CIT Act (2) (2/19/18)

We continue our series of articles exploring the rules for taxing a permanent establishment (PE) in Latvia under the new Corporate Income Tax (CIT) Act effective from 1 January 2018. The first article described the PE's taxable items. This article outlines some practical difficulties in timing the allocation of profit and highlights things to consider when it comes to keeping books.

As we said in our previous article, 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). There are certain areas, however, that require an interpretation from the tax authorities.

## Timing of allocation

We conclude from the current rules that profit is considered to be distributed when cash actually flows out of the entity.

To shed some light on the subject, we will analyse an example of PE taxation provided in Appendix 1 to the Cabinet of Ministers' Regulation No. 677.

XCO, a Lithuanian company, has a trade agent in Latvia, Mr Berzins. He is resident in Latvia and authorised to enter into contracts on behalf of XCO. As a result, the company has a PE in Latvia. The PE's activities generate a profit of €10,000 for the year (revenue of €100,000 less COGS of €90,000). Under the CIT Act the PE has no taxable item until the profit is distributed.

If the PE and the company have separate bank accounts and the revenue generated through the PE in Latvia is collected into the PE's separate bank account, and XCO keeps separate accounting records for the PE, then any profit will constitute the PE's taxable base when transferred to XCO. Accordingly, the PE can measure the amount of profit to be transferred to XCO after deducting COGS and any allowable administration expenses.

But how do we measure the taxable base if XCO and the PE have a joint bank account with revenues going straight into XCO's bank account?

If XCO keeps no separate accounting records for the PE and sells directly to customers, who pay into the joint bank account, the total revenue of €100,000 will constitute XCO's taxable base for Latvian CIT purposes. However, if Mr Berzins keeps separate accounting records and holds documentary evidence defining and supporting the type of expenditure (with revenues still going directly into the joint bank account) the PE's taxable base will only consist of the profit (i.e. 10,000).



Here's what we conclude from the current rules. If revenues gained through the PE in Latvia are collected into XCO's bank account, then total revenues will constitute the PE's taxable base in the month XCO receives the payment, unless separate accounting records are kept and monthly costs attributable to the

branch can be identified.

Since the current law is not clear enough about year-end adjustments, in our coming articles we'll be exploring what the PE should disclose on its monthly tax returns and how Estonia treats the timing of allocation.

*(to be continued)*