

Taxation of permanent establishments under new CIT Act (3) (2/20/18)

To pick up where we left off last week, this article explores how the timing of allocation is treated in Estonia and what the PE should disclose on its monthly corporate income tax (CIT) returns.

Estonian treatment

An outflow of cash does not necessarily mean that any profit has been taken out of the Estonian PE for CIT purposes. When payment is made into a different bank account, the PE will book a claim against its head office, which is also an asset. Such a transfer is not, therefore, considered a profit distribution.

When measuring profits attributable to the PE, income as well as expenses incurred in generating that income should be taken into account. The non-resident company is required to keep separate tax records for the PE in order to measure the amount subject to reporting and taxation. Accordingly, a separate set of tax accounting records should be kept in a manner that enables a third party qualified in accounting to obtain a true and fair view of the taxpayer's financial position in a particular period. CIT is payable when any profit attributed to the PE is taken out of it and becomes part of the tax base. It does not, therefore, matter when cash flows out, but rather when the PE is deprived of its right to a receivable or an asset.

The tax period in Latvia

The new CIT Act provides that once a tax base arises, the taxpayer should file a monthly tax return on or before the 20th day of the following tax period. This requirement applies to PEs and companies alike. If a tax return is not filed, this means that no tax liability arose in that month. The tax base can be adjusted for non-business expenses only in the month they were incurred. Thus, if an adjustment is still needed at a later date, the tax authority will charge interest on arrears.

Section 17(9) of the new CIT Act provides that the PE's reporting period is a calendar year and a tax return should be filed for the last tax period along with the PE's balance sheet and profit and loss account. This raises the question of whether the PE (in last week's XCO example) can adjust its tax base after the year-end allocation of expenses if CIT has been paid on gross revenue throughout the year? Also, would it be possible to make a year-end adjustment relating to non-taxable 10% of costs incurred in administering the PE under paragraph 24 of the Cabinet Regulation? What if only a certain percentage of gross revenue is allocated to the PE?

In summary, here are key CIT points to consider if you have or plan on having a PE in Latvia until the tax authority settles the above uncertainties:

1. The PE as a taxpayer should keep separate tax accounting records in a manner that enables a third party qualified in accounting to obtain a true and fair view of the taxpayer's financial position in a particular period (preferably the PE should have a separate bank account);
2. The taxpayer should revise possible expenses to be allocated to the PE and carefully plan accounting for them;
3. Even where the approach to accounting is carefully planned, books properly kept, and the tax base clearly and regularly reported, the taxpayer should also consider the transfer pricing implications of

allocating profits to the PE.

The PE's transfer pricing should be aligned with the approach to the tax base. We'll be exploring this in our coming articles.