CIT treatment of PE payments to non-resident owner (3/4/19)

Last year we posted a series of articles 1, 2 and 3 on the corporate income tax (CIT) treatment of a permanent establishment (PE) under the new CIT Act. This article explores the PE's payments to its non-resident owner that may be recognised as a quasi-dividend.

The legal framework and its interpretation

Section 1(8)(4) of the CIT Act provides that a quasi-dividend is any payment the PE makes to its non-resident owner that is not considered an expense incurred by the owner in ensuring the PE's business operations.

Paragraph 23 of the Cabinet of Ministers' Regulation No. 677, *Applying provisions of the CIT Act,* provides that income extracted from a Latvian PE during a tax period comprises –

1. any payment the PE makes to its non-resident owner that is neither the owner's expense towards the PE's business operations under paragraph 22 nor a payment for goods supplied under paragraph 25;
2. any income gained by the non-resident directly through the Latvian PE and attributable to it.

In conjunction with paragraph 24, the above implies that CIT is chargeable on any payment the PE makes to its non-resident owner that is neither a payment covering the owner's expenses towards the PE's business operations nor a payment for goods supplied, nor 10% of any other payment the PE makes to its owner.

Although the explanatory rules do not exhaustively list all cases where a transfer of the PE's funds to its non-resident owner does not make the CIT base, this does not mean that the provisions of the CIT Act should be interpreted strictly. Each payment should be assessed according to its legal and economic substance to achieve the purpose of the CIT Act.

We believe that systematic interpretation of other provisions of the CIT Act shows that the concept of PE payments should be linked to an explanation of the term "payments" in paragraph 39 of the same Cabinet Regulation, which is applicable to payments made to any person that is based, formed or incorporated in a tax haven. This paragraph explains that the term "payments" means any payments that make or will make a difference to the taxpayer's financial indicators other than declared dividends. We believe that the explanation of the term "payments" in that paragraph by analogy extends to the PE's payments to its non-resident owner under the CIT Act.

Thus, in assessing whether the PE's payments to its non-resident owner should be recognised as a quasi-dividend, each payment should be assessed separately according to its legal and economic substance, as confirmed by practice.

Practice

The PE as an insurance company provides capital management services and ensures financial stability in

accordance with insurance legislation. To manage capital efficiently and increase profits, the PE's non-resident owner has entered into an investment contract with an investment company. Under the PE charter and the investment contract, the PE makes payments into its owner's investment account managed by the investment company. The conclusion is that in this case the PE's payments are made into the investment account for investing in financial instruments and ensuring the PE's capital management rather than being made available to its owner for business dealings. So these payments according to their economic substance do not qualify as a quasi-dividend under section 1(8)(4) of the CIT Act if relevant criteria are met.

We recommend evaluating all of the PE's payments to its non-resident owner according to their economic substance in order to establish whether they should be recognised as a quasi-dividend under the CIT rules. If necessary, we recommend applying to the SRS for a written interpretation or ruling on the CIT treatment of particular payments the PE makes to its non-resident owner.