Arm’s length principle in non-resident’s transactions with permanent establishment in Latvia (2/36/20)

A non-resident foreign entity wishing to start business in Latvia is likely to face the question of whether to incorporate a subsidiary or open a branch or a permanent establishment (“PE”). To answer this question, the foreign investor should evaluate various legal, administrative and tax aspects. This article explores how profits are allocated to the PE, an aspect that can play a decisive role in making this decision.

International requirements

It might seem that from a legal perspective and in terms of the administrative burden, it is easier to register a PE. And investors actively opening branches in many OECD countries are used to the view that under the OECD Model Tax Convention on Income and on Capital and according to the Authorised OECD Approach (“AOA”) a branch is considered a separate enterprise for profit allocation purposes so the transfer pricing rules for branches and subsidiaries do not usually differ.

According to the AOA, when it comes to allocating revenues, costs and profits to the PE, we need to assess its functions performed, risks assumed and assets used, and then allocate a level of profit the PE would have received if it were operating as a separate independent enterprise. And from 2010, the OECD commentaries to the Model Tax Convention explain that for profit allocation purposes any activities between the PE and the foreign head office (“HO”) are treated as transactions between separate enterprises where fees paid should be arm’s length.

Thus we might conclude that from a transfer pricing perspective, a PE’s or branch’s operations do not differ from a subsidiary’s operations, and the decision to incorporate a subsidiary or to open a branch should therefore be based on other legal and administrative aspects.

However, the allocation of profits to a Latvian-registered PE is not so straightforward.

Latvia’s reservation

When looking at mechanisms for allocating profits to the PE and its taxable base for corporate income tax (“CIT”) purposes, we should consider the Latvian CIT legislation and be aware of the important fact that Latvia has made a reservation on article 7 of the 2010 Model Tax Convention (with OECD commentaries), which lays down principles for allocating profits to a Latvian-registered PE.

This means that Latvia has refused to adopt changes to the interpretation of article 7 effective from 2010, i.e. Latvia still applies the 2008 Model Tax Convention’s approach to allocating profits to PEs of all the countries that have an effective double tax treaty with Latvia. The reservation mainly affects only certain transactions between the HO and its PE in Latvia that often form a substantial part of the PE’s business.

A change in the approach to profit allocation

Since a PE usually arises when the HO expands its operations in another country, the HO takes an active part in the PE's business and provides support, from devising a joint management and business strategy to performing administrative functions, such as keeping books, handling staff matters, and drafting and reviewing legal documents. The HO may have to finance the branch's operations by lending and allow it to use the HO's intangible assets, such as trademarks and patents. Based on the AOA and the arm's length principle, the HO should receive an arm's length fee for the functions performed, risks assumed and assets used for the benefit of each branch. Here lies the difference between how article 7 of the Model Tax Convention was interpreted before 2010 and how this is done later on.

In its 2008 commentaries, the OECD made it clear that the HO can allocate to the PE only costs it incurs for the branch's benefit, without adding a profit element. In other words, if the HO allocates to the PE any costs with a markup as part of management or other services, or if the HO charges interest as part of the financing transaction unless those are the HO's third-party expenses covered by the PE, and if the HO demands a royalty from the PE for using the intangibles, then the markup, the interest and the royalty will not be deductible from the PE's taxable income.

From 2010, however, the OECD permits the arm's length principle to be applied in certain transactions between the HO and its PE, allowing the HO to include a profit element in its transfer price.

Latvian statutory requirements

The Latvian legislation on taxing PE profits is even further away from the OECD's 2010 interpretation. When it comes to the PE's taxable base, the Cabinet of Ministers' Rule No. 677 provides that all income the HO withdraws from the PE during the tax period attracts CIT, with the following exceptions:

- The PE's payments that cover any expenses, in whole or in part, actually paid in the HO's transactions with resident or non-resident third parties and directly linked to the PE's business;
- The PE's payments to the HO for goods supplied;
- an amount that does not exceed 10% of the HO's third-party expenses linked to the PE business, and of the payments for goods supplied, if the PE holds a letter of confirmation (on paper or electronic) issued by the HO that the payments are necessary to cover the HO's general administrative and operational expenses directly linked to the PE's business and are not included in the cost of those goods.

Accordingly, the Latvian legislation prevents the HO from adding a profit markup to its costs being allocated to the PE in Latvia and restricts the HO's right to allocate its general administrative and operational expenses to the 10% threshold.

Conclusion

If the foreign investor believes the HO creates a high added value in the PE's business and wants an appropriate return including a markup, it is advisable to consider incorporating a subsidiary, rather than opening a branch, because the parent's transactions with the subsidiary in Latvia are subject to the arm's length principle.