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When starting business abroad don’t forget to assess tax risks (1) 2/6/21


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Publicly available information on Latvian companies growing their exports or launching business abroad is always welcome, yet they have to meet foreign administrative requirements, including legal issues (work safety, employment, permits and registrations) as well as accounting and taxation. This article explores the obligation to pay foreign corporate income tax (“CIT”) and employee taxes potentially facing a Latvian company. VAT rules are usually assessed separately and a VAT registration requirement can arise where there is no obligation to register for other taxes, hence no VAT comments here.

Meeting foreign administrative requirements can be a complicated and lengthy process but if you start early and assess inherent risks you can make your foreign business a success.

Foreign tax authorities closely monitor any non-resident (including Latvian) company’s obligation to register for foreign taxes and pay them. There are various mechanisms in place the tax authorities can use to obtain a variety of information on the Latvian company’s business activities abroad, including analysing its VAT returns and appendices as well as information available from various registers, the immigration office, and trade unions. The foreign tax authorities will also question the Latvian company’s business partners in order to determine its real presence in the foreign country, the terms of business, and the overall nature of the industry it operates in, and to set out grounds for having to pay foreign taxes.

If the foreign tax authority asks the Latvian company to register and pay taxes, then you should be aware that the authority has sufficient information to support their request. What the Latvian company can do is either register and pay foreign taxes or prepare sound counter-arguments for defending its position.

What is a permanent establishment (“PE”)?

When it comes to applying CIT and payroll taxes, it is crucial to determine whether the company has a PE in the foreign country. This task involves analysing local and international rules.

In today’s dynamic business environment a company incorporated in one country often carries on a business in another, such as selling goods, providing services, maintaining a representative office for marketing purposes, or relocating an essential business function there. So the PE concept means that the company has a fixed place of business in the foreign country for tax purposes.

First of all, having a PE affects the company’s obligation to pay CIT or a similar tax, so the company has to register a presence in the foreign country for CIT purposes, work out how much of its income is attributable to the PE, and pay CIT on that income. Note that certain types of business such as international traffic have a different set of rules.

Having a PE can also affect the company’s obligation to register and pay foreign payroll taxes, in particular personal income tax (“PIT”). This obligation arises from the general provisions of double tax treaties (DTTs) and their exclusions. In short, payroll taxes on employees working for the PE must be paid in the foreign country, even though they are tax residents of another country staying there temporarily (not reaching 183 days in any given 12-month period).

PE criteria

National legislation on PE criteria varies slightly from country to country, yet most countries rely on some generally accepted criteria: permanence, an actual place, and business done in a foreign country.

The PE is also one of the concepts governed by DTTs. Latvia has a wide range of DTTs, and information on their status is available from the Finance Ministry’s website. In general, if DTT provisions are more generous to the taxpayer they will override national law, so before launching your business abroad we suggest you at least consider DTT provisions.

DTT article 5 provides that a PE means a fixed place where a company fully or partly carries on a business. Typical examples include the management seat, branch, office, factory, workshop, and oil or gas extraction site. The DTT provides that such a fixed place will not create a PE if the company uses it for a limited set of activities such as storing, displaying and supplying its own goods, receiving and passing information, or doing other preparatory and auxiliary activities. In that case we need to assess the nature of the company’s business to determine whether particular activities can be labelled preparatory or auxiliary. For example, marketing activities carried out by an advertising and marketing company in a foreign country are part of its core business and do not qualify as auxiliary activities.

A PE can also arise if the company has a person or persons acting for it in the course of business in a foreign country. Those persons can be employees of the company, employees of its related companies, or any other service provider that operates in the foreign country almost exclusively for the non-resident company. For example, a Latvian wholesale company has a representative office in a foreign country or simply rents a space where its trade representatives work to promote sales. If they are authorised to negotiate prices and sign contracts with customers, the company has a PE.

DTTs usually contain specific provisions for work done on building and mining sites. For a building site in the foreign country (known as a construction PE) we need to assess its duration.

It is also advisable to analyse the foreign legislation as it can lay down some conditions to clarify the DTT, for example, by defining the range of functions that clearly amount to a PE.

(to be completed)