Corporate tax treatment of expenses attributed to permanent establishment in Latvia 3/12/21

A non-resident company that allocates various expenses to its permanent establishment ("PE") in Latvia might wonder whether the PE can fully deduct all those expenses for corporate income tax ("CIT") purposes. This article explores the non-resident's staff cost allocations to the PE.

Background

A non-resident company has a PE in Latvia and other countries. Many of the management functions and several specialist functions cover the company's entire operations, including the PE's business, and those functions are performed by the staff employed by the non-resident. Since these costs are also related to the staff employed by the Latvian PE, the expenses are split between the non-resident and its branches, including the Latvian PE. The costs below are regularly allocated during the year:

- Employment pay (wages, salaries, vacation pay, and sick pay);
- Share-based payments (the variable part of employment pay);
- Telecommunications;
- Training and business trips;
- Staff health.

Can the Latvian PE fully deduct these costs for CIT purposes?

The legal framework

The CIT Act provides that the taxable base of a PE registered in Latvia should be arrived at by adding up its taxable items in Latvia and abroad for the tax period. Dividend equivalents are amounts the PE pays to the non-resident that do not qualify as the non-resident's expenses incurred in ensuring the PE's business.

Paragraph 22 of the Cabinet of Ministers' Rule No. 677, Application of Provisions of the Corporate Income Tax Act, provides that when drawing up a profit and loss account for CIT purposes, any expenses directly related to the PE's business that are actually paid in the non-resident's transactions with other resident or non-resident persons can be deducted from the PE's profit. A deduction is allowed only if the expense is supported by documentary (paper or electronic) evidence and only to the extent the expense is attributable to the PE's business. It is important to note that paragraph 24 of Rule 677 specifies expenses that are deductible up to 10%.

So the PE can make the following payments to the non-resident free of CIT:

- Amounts paid for goods supplied;
- Expenses directly related to the PE's business that are actually paid in transactions with other persons according to supporting documents;
- Other expenses up to 10% of the non-resident's expenses related to the PE's business and of the consideration for goods the PE pays to the non-resident, subject to confirming that the payments are necessary to cover the non-resident's general administrative and operating expenses directly related to the PE's business.

The CIT treatment of labour costs attributed to the Latvian PE

In evaluating costs attributed to the PE and applying paragraph 22 of Rule 677 we need to bear in mind that any expenses directly related to the PE's business that are actually paid in the non-resident's transactions with other persons can be deducted from the PE's profit, and the term "other persons" includes employees: any labour costs incurred by the non-resident's head office or its non-Latvian PEs are treated as expenses paid in transactions with other persons. Thus, if an invoice the non-resident or its non-Latvian PE issues for actual expenses attributable to the Latvian PE (and not for the value of services) contains a breakdown of each item, i.e. direct and indirect labour and overhead costs supported by documentary evidence (a payslip or an invoice for third-party services etc) in written (paper or electronic) form, the branch can deduct such expenses from the taxable base.

Accordingly, when labour costs are split between the non-resident and its PEs, the Latvian PE can deduct the labour costs attributed by the non-resident, including employment pay and share-based payments (the variable part of employment pay), as well as training, telecommunications, business trips and other labour costs, so those should not be added to the taxable base. It is important to provide a cost breakdown based on supporting documents and there must be no markup on those costs.