# Taxation of permanent establishments: SRS guidance (2/11/20)

To fill the gap in Latvian legislation when it comes to taxing a non-resident company's permanent establishment ("PE") in Latvia, the State Revenue Service ("SRS") published guidance in August 2019 explaining their approach to PE taxation with examples, which may at first seem quite aggressive, especially considering that nearly all of the PE's outgoing payments attract corporate income tax ("CIT"). This article explores the SRS approach.

The PE and exceptions

Under the CIT Act, the tax base of a Latvian PE is to be determined by adding up taxable items attributable to the PE and profits extracted from the PE during the tax period. The tax base includes the same items that are generally taxed in companies under section 4 of the CIT Act. Any payment the PE makes to its non-resident head office ("HO") is treated as a dividend and goes into the tax base. As a result, it seems that nearly all payments the PE makes to its HO are taxable.

The Cabinet of Ministers' Rule No. 677 on how to apply provisions of the CIT Act, together with the guidance on charging CIT on PE profits published by the SRS on 12 August 2019 (the "Guidance") explain the taxation of PEs. The explanation and examples support the principle that all payments the PE makes to its HO are taxable, with only a few exceptions:

- *10% of the PE's general and administrative costs incurred by the HO*. For example, if the HO has incurred internal general and administrative expenses of €5,000 attributable to the PE, and the PE covers this cost, then €4,500 will attract a 25% tax and the remaining €500 will not make the tax base;
- *Pass-through costs.* The HO's third-party costs attributable to the PE are deductible only if supporting documents (written or electronic) are provided;
- *Payment for purchases.* Only an arm's length price of any goods supplied is deductible in the PE.

Amendments to the CIT Act effective from 12 February 2020 charge CIT on any asset the PE transfers to the HO if Latvia loses the right to tax that asset as a result of the transfer (with certain exceptions if transferred for up to 12 months). These amendments are similar in nature to the idea of exit tax.

The SRS's approach is clearly inconsistent with the internationally accepted OECD approach to attributing profits to PEs. This creates mismatches between countries, provides grounds for disputes, and raises various discussions, interpretations and questions for taxpayers. This issue is being debated by the Ministry of Finance, and we expect some clarification soon.

In the meantime, we advise careful planning whenever you are about to open a branch in Latvia. Certain issues such as invoicing might need addressing early on.