When starting business abroad don't forget to assess tax risks (2) 3/7/21


Director, Tax, and Head of Pan-Baltic People and Organisation Practice, PwC Latvia

Irena Arbidane

This article wraps up what we wrote last week about the obligation to pay corporate income tax and payroll taxes when doing business abroad.

Registering a permanent establishment ("PE")

There are two types of PE registration: voluntary and compulsory.Voluntary registration means that the company registers a PE for tax purposes simultaneously with starting business in the foreign country and before the foreign tax authority raises this issue. The company chooses to register its presence for tax purposes according to the foreign legislation. This can involve registering a branch or a PE. In certain cases the company can also choose to incorporate a local company. In such cases the company recognises itself as a payer of foreign corporate income tax ("CIT") and personal income tax ("PIT"), and in certain cases also social insurance contributions. The company keeps separate books and calculates, pays and reports taxes according to local laws. It is important to analyse in advance the transfer pricing ("TP") principles governing transactions with the Latvian company to properly measure the level of profit in the PE (branch or company) supported by the group's evidence-based TP policy.

Compulsory PE registration takes place when the foreign tax authority asks the company to do so. As stated above, the tax authority will typically have conducted a preliminary research to verify the need to register a PE and pay taxes assessed by the tax authority. In that case the company should be prepared to keep defending its position, as it will have to gather and submit evidence to the tax authority within fairly short time limits, in the local language, and on specific tax issues. This PE registration is more complicated and takes extra time and money.

Our experience suggests that most Latvian companies tend to face compulsory PE registration, so it is advisable to hire local tax consultants with experience in handling issues with tax authorities.

Registering a PE also means an obligation to pay CIT on the portion of profit made through the PE. While various factors can affect profit levels, they are mostly based on the PE's functions and activities. For example, the profit for a PE that only provides certain intragroup services, such as marketing or logistic functions, will be an arm's length fee (margin) for performing those functions.

A key obligation for any PE is to pay PIT for employees working in the PE's country or in another country if their remuneration costs are attributed to the PE. In certain cases, depending on rates, the expected PIT burden can be heavier than the CIT burden. Another thing to watch out for is double taxation of the same income in the hands of employees. If that happens, the company or the employee, or even both together, should take certain steps to recover the Latvian PIT paid.

How can the foreign tax authority identify a PE?

Foreign tax authorities are actively identifying construction-related PEs according to the information given on companies' VAT returns and their appendices, which allows the authorities to identify transactions related to real estate in a particular country.

International law provides that a Latvian company will have a construction PE if it uses its employees or contractors to do work on building, construction or assembly sites, or to carry out related supervisory or advisory activities in the foreign country. A PE will arise only if such activities exceed the period prescribed by each double tax treaty (e.g. six months in the Danish treaty and nine months in the German treaty).

These rules have many exclusions for work interruptions and procedures for adding up the total time of projects, which can vary from country to country.

Accordingly, a Latvian company that provides construction or related services for more than six or nine months will have to register a PE. Depending on the country, registration can be required from the first day of work or at the end of the period.

A dependent agent's PE can be identified by checking the foreign company's registration for payroll tax purposes, as well as employee registrations for tax purposes and with trade unions or associations.

Conclusion

In summary, the foreign tax authority has every legal ground and practical method to detect a PE. If the company has not assessed its PE risks in the foreign country, it can later face an urgent obligation to register a PE retrospectively and pay foreign CIT. In addition, payroll taxes should be paid for employees working for the PE. To avoid this urgency, we recommend assessing PE risks early to prevent a tax audit by the foreign authority, which can lead to extra tax assessments and interest on arrears.