

Why permanent establishment costs are essentially employment tax costs 2/28/23



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Globalisation means it's common for companies to have their corporate clients and various procurement projects in countries other than their main place of business. To properly benefit from foreign procurement projects, it's important to assess not only the benefits but also risks associated with such business opportunities, particularly tax risks. If your company has a permanent establishment (PE) in a foreign country, it's important to be aware of the corporate income tax and payroll tax implications of operating there. In this article, we take a look at employment tax risks and key issues to consider.

Personal income tax (PIT)

If a Latvian company wins a project in Lithuania, for example, that requires its Latvian workers to make short visits to Lithuania, the PIT treatment is quite straightforward under the double tax treaty between the two countries – PIT is payable only in Latvia based on the following assumptions:

- Workers don't spend more than 183 days in Lithuania in a given 12-month period.
- Their pay comes from their home employer.
- The Latvian company doesn't have a PE in Lithuania (no remuneration costs are borne by a PE).

However, if there is a PE in Lithuania (e.g. a construction project exceeding six months causes the company to have a fixed place of business there), this is a game changer in terms of compliance requirements and PIT treatment. If workers spend more than six months in Lithuania and are paid by their Latvian employer, but their payroll costs are allocated to the PE, then PIT should generally apply where the work is done (in Lithuania).

Social insurance contributions

Different rules apply to social insurance contributions. To maintain the status of a socially insured person in one country while being employed in another, it's necessary to find out whether the two countries have entered into an agreement on social insurance. This agreement allows the worker to take out a certificate confirming their status as a socially insured person in their home country. This is called A1 across the EU/EEA or a certificate of coverage for countries that have a social security agreement with Latvia (Australia, Belarus, Canada, Russia and Ukraine). A certificate can be applied for by the employer or the worker. Holding a certificate ensures the individual remains socially insured in their home country if the expected duration of work abroad doesn't exceed 24 months. A certificate will not be issued to a worker who is posted to replace another worker doing a foreign assignment.

Should the worker's remuneration change?

To ensure workers can freely move across the EU and are paid fair wages during periods they work abroad, the European Parliament has adopted Directive 2014/54/EU. This states that when an employer posts staff to work in a foreign country, e.g. on a project won in a procurement tender, the employer must ensure the worker is paid at least the minimum wage of the foreign country they are working in.

From a practical perspective, this means that if a Latvian employer posts a worker from Latvia to carry out a project in Austria, for example, and their base pay in Latvia is EUR 1,200, the employer must pay EUR 1,500, which is equivalent to the Austrian minimum wage. In other words, since the foreign minimum wage exceeds domestic levels, non-compliance with the directive may bring not only penalties but also higher total payroll tax costs. It's therefore important to ensure the company is aware of the requirements it has to meet.

Risk management

Failure to comply with international law may result in a high tax risk and substantial costs in the form of payroll taxes. When a company starts operating abroad, this might create a relatively small corporate income tax burden, as it depends on the company's profit indicators. On the other hand, there is a significantly higher burden of payroll taxes, which depends on the number of workers employed abroad and their pay, especially considering that they tend to be highly skilled.

The member states' tax authorities are cooperating closely and exchanging information quickly, so non-compliance with international law and failure to pay local taxes may have serious consequences for any company. We have seen many real-life examples of the tax authorities significantly restricting a company's operations by demanding payment of tax arrears or charging its assets. Companies should always think through all the risks associated with their foreign operations and consult beforehand to ensure they meet national requirements from the outset.