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THE EFFECT OF PERMANENT ESTABLISHMENT LEGAL STATUS ON FINANCIAL STATEMENT SUBMITTED TO TAX AUTHORITY

Bachelor's thesis

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ABSTRACT

Permanent establishments are often referred to as subsidiaries or a complete legal entities like other various forms of businesses. Organization for Economic Co-operation and Development(OECD) through its model tax conventions has defined permanent establishment as a fixed place of business where business conducts their activities fully or partially. Legal entities prepare financial statements and includes some disclosures which are useful to users. The composition of financal statements especially balance sheets shows assets and liabilities (which includes equity), this signifies a legal person or certain ownership.

The aim of this thesis is to ascertain the effect permanent establishment status have on the preparation of financial statements they submit to tax authority. The thesis also aims to clarify if permanent establishment are a legal, semi legal or non legal person. How will financial statements of permanent establishments be prepared based on their status.

The study finds by using qualitative research method in analysing articles, books, journals, previous academic lietratures and OECD conventions that permanent establishments are not fully a legal entity but can be regarded as a semi legal entity as they have cetrain similarities of a legal person. The author also found that financial statements (balance sheet) of permanent establishments are different from legal entities as they do not have equity and it was replaced with free capital which does not show ownership but simply a cover for liabilities of activities performed. The author suggested having a standard accounting rule that equity can be replaced with a balancing number or difference between assets and liablities to equate the balance sheet.

Keywords: Permanent Establishments, Financial statements, Tax authority, Legal Entities

INTRODUCTION

Permanent establishment concept has been confused with several legal entities and thus there is a need to understand the concept, framework and when the need arise. There are various form of legal entities ranging from sole proprietorship, partnerships, corporations and limited liability companies which are established under legal statutes. They are required to prepare financial statements annually and are subjected to taxation according to the local tax laws of the state of operation.

Legal entities have been in existence for a very long time and shaped the way financial statements have been prepared for years with International Financial Reporting Standard (IFRS). Permanent establishment is crucial for international taxation as it gives proper direction about taxing rights and country of residence. Understanding the right to tax is important especially for international companies who have business outside their usual domain or territory. Permanent establishments are sometimes considered as subsidiaries of the parent company and thus given a full business legal entities status which can expose them different set of tax.

Organization for Economic Cooperation and Development (OECD) through its model tax conventions on income and capital 2017, has try to clearly state “permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on”.

This bachelor's thesis reviews the effects status of a permanent establishments have on financial statements submitted to tax authorities. There is a need to know which financial statements are submitted by permamnent establishments to tax authorities if they are considered a legal, semi-legal or non legal entity. Legal entities have standards and how financial statements should be prepared and submitted. There are also necessary disclosures to be included in financial statements of leagl entities.

This thesis will use qualititative method of research. Theoritical analysis will be used through reference to books, articles, journals, OECD conventions, governement legislations and also published data.

Research questions:

1. Are permanent establishments a legal, semi legal or non-legal person?
2. How are financial statements of permanent establishments prepared based on their status?

The qualititative research method will be used to anaylse these research questions through historical analysis combined with articles, journals and legislations giving an insight into how permanent establishments are operated.

The study starts by definining legal entities and its various forms then the need for permanent establishments concept and why it is needed by states. It also discusses permanent establishments situation in Estonia as a case study.

The second part discusses financial statements, objectives of financial statements, users and disclosures needed during preparation. Financial statements of permanents establishments are then discussed and contents as it relates to their status. This also include conclusion and recommendations based on theoritical analysis.

1. LEGAL ENTITIES DEFINITION

The author believes there is a need to understand the definition of legal entities, its various forms, legal personality and asset partitioning. They are essential in clarifying a legal personal and permanent establishment.

According to Lexico Dictionary, a person, company, or other body with legal rights and responsibilities. A legal person is an individual or non-human individual that is regarded as though it were a person for legal reasons only.

A legal person may sue and be sued, own property, and enter into contracts, among other things.

Legal entities are companies, institutions and organizations that are recognised to possess a legal rights and responsibilities as a person which includes preparing and submitting taxes (McMenemy, 2020). They are empowered to conduct business transactions and undertake contracts which are legally binding.

According to *The New Merriam-Webster dictionary*, legal entity is an entity (as a corporation or labor union) having under the law rights and responsibilities and especially the capacity to sue and be sued.

Legal entities engage in contracts and fulfil the conditions of those contracts. They are liable for their decisions and can be held accountable even in the court of law.

1.1 Various Forms of Legal Entities

According to (McMenemy, 2020), there are various forms of legal entities depending on the region, country or continent. The structure varies from corporations, partnerships, limited liabilities etc.
The most common forms of legal entities aaccording are:

Partnership: This involves two or more busniess owners that have an agreement to share profit and losses together. It can be divided into 2 namely : General – where profit and losses are shared equally among partners or Limited – where one partner has more control over another in terms of contribution, running the business and sharing profit or losses (Stowers, 2020).

According to Estonian Commercial Code (section 79), a partnership is described as a company in which two or more partners function under a common business name and are jointly and severally responsible for the general partnership's liabilities with all of their properties.

Corporation: A corporation is an enetity separate from its proprietors. It has its own legitimate rights, free of its proprietors – it can sue, be sued, own and sell property, and sell the privileges of possession as stocks (Stowers, 2020). According to Estonian Commercial Code (section 221), A corporation is an entity that has a share capital split into public limited company shares. A shareholder is not directly responsible for the public limited company's responsibilities. A public limited corporation is required to meet its duties for all of its properties.

Limited liability company (LLC): A limited liability company (LLC) is a mixture structure that permits shareholders, clients or investors to restrict their own liabilities while enjoying tax and advantages of an association (Stowers, 2020). Under a LLC, individuals are protected from individual responsibility for the obligations of the business in the event that it can't be demonstrated that they acted in an unlawful, untrustworthy or flighty way in doing the exercises of the business (Stowers, 2020). According to Estonian Commercial Code (section 135), a limited liability company (LLC) is a business with a share capital split into private limited company shares. A shareholder is not directly responsible for the limited company's responsibilities. A limited liability company is obligated to meet its duties for all of its properties.

1.2 Legal Personalities and Asset Partitioning for Entities

Legal entities have personalities that enable them to engage in economic activities, enter contacts, have duties and obligations. To be a legal person is to be the subject of rights and duties (Salmond 1911). To confer legal rights or to impose legal duties, therefore, is to confer legal personality.

Predictability of societal action determines rights and duties which determine legal personality. Legal personality is the capacity for legal relations.

Legal personality is abstraction of which legal relations are predicated, or as a name for the condition of being a party to legal relations (Smith *Legal Personality*). Legal personality gives a form of identity which makes entities unique and distinct from individuals.

Asset partitioning involves restricting liability of the owner and shielding entities (Lab and Vananroye *asset partitioning*). It involves allocating pool of assets to cover certain liabilities.
According to Hansmann and Kraakman (2000) asset partitioning is made up of two sections. The first is the creation of a separate pool of funds that are affiliated with the company and different from the beneficiaries' and managers' personal assets.
In turn, this is accomplished by identifying juridical individuals (legal entities) that are separate from actual humans and may possess properties in their own names. When a business is incorporated as a separate company, the properties it owns become a designated pool of firm assets.

The second aspect of asset partitioning is the allocation to creditors based on their importance in the assigned pools of assets that derive from the creation of a legal entity. This prioritization will take two different forms. The first grants to the firm's creditors a claim on the properties connected with the firm's activities, which takes precedence over the claims of the firm's beneficiaries' personal creditors (Hansmann and Kraakman 2000). This is referred to as affirmative asset partitioning because it establishes a separate pool of company assets as bonding assets for all of the firm's contracts. The second kind of asset partitioning is just the reverse, giving personal creditors of the beneficiaries a claim to the beneficiaries' respective personal properties above the firm's creditors (Hansmann and Kraakman 2000). We call this defensive asset partitioning to show the common belief that it protects the beneficiaries' properties from the firm's creditors.

1.3 Tax Determination for Legal Entities

Legal entities are required to pay taxes on income earned to the authority in their jurisiction. Taxes paid is determined on the form of legal entity the business is classfied into and this is common practise all over the world.

A sole proprietor pays taxes directly on the profit earned from the business as he is the sole controller and liable for all debts. Partners pay taxes according to the share of profits due to each partner as the business belongs to more than one person (Klein, W. A. 1972). A corporation and limited liability entities pay taxes on the income earned from busniess activties after deducting all necessary expenses.

1.4 OECD Model Agreements

The OECD (Organization for Economic Co-activity and Development) is a worldwide association of 35 individuals. Estonia joined OECD in 2010. The OECD has built up a model agreement that can be utilized by contracting parties as a model for closing assessment settlements with one another. The OECD Model Agreement comprises of 4 sections: a presentation, the arrangements of the understanding, a discourse, and OECD suggestions to help carry out the arrangements and remarks of the arrangement. According to OECD (Model tax Convention on income and on Capital 2010, full version 2012) the primary adaptation of the OECD Model Convention was distributed in 1963, followed by a revised one in 1977.

1.4.1 Allocation of Taxes

An outline of the standards for allotting taxing rights addresses the topic of what organizations need to pay for. The reason for tax sharing is to guarantee equivalent tax collection between nations (Avi-Jonah, R. 2014). In the 1960s, the rule of fiscal neutrality turned into a significant piece of monetary convention. Tax dividing among systems was, and still is, talked about today, essentially based on neutrality (Andersson 2016) This rule depends on the thought income tax rights are shared similarly between nations engaged with economic activities (Lopez, E. 2015).

All the more explicitly, the reason for the guideline is to keep tax collection from dispensing rivalry in the worldwide market in any capacity (Skaar 1991). For instance, two organizations might be enrolled in various nations yet work in a similar country. While taxing rights of these organizations have a place with the nations of residence, the two contending organizations are charged diversely as indicated by the tax laws of the nation of residence and in this manner the opposition between the two organizations is influenced and in this way where the organization contributes is influenced. This view shows, source-country tax assessment could be liked, which takes out the chance that tax collection could influence rivalry. It is referred to as capital import neutrality (Skaar

1991). Neutrality implies that both organizations working in the source market get a similar expense rate.

1.4.2 Why States Need the Concept Permanent Establishments

The Organization for Economic Co-Operation and Development ('OECD') (2008:80) expressed that the idea permanent establishment is significant in the understanding and utilization of double taxation since it decides a country's entitlement to tax a non-local business activity inside that country.

The idea permanent establishment is utilized in, double taxation, and applies to a business of one state which has a permanent establishment in another state. As per article 7(1) of the OECD, the presence of a permanent establishment in a tax locality decides the privilege of the area to tax the income of the permanent establishment (OECD, 2008). The taxing right of the tax area are restricted to the degree that business income is generated from that permanent establishment (Passos, 1986).

Article 5 of the OECD contains a meaning of a permanent establishment. An in-depth review of the definition of the term shows how they can be recognised to be permanent establishments. There are certain criteria to be met and once they are established, it confirms that adequate and legal business activities emanate within the fixed place of business. With this assertion, the need for the concept for the concept of permanent establishment is to identify the prerequisites which shows that large and legal amount of business happen within a foreign tax locality.

Permanent establishment is a fixed place of business, through which the business of an enterprise is wholly or partly carried on. The existence of a place of business (premises, machinery or equipment) must be established at a distinct place with a certain degree of permanence. The business should be carried on usually by the persons who, in one way or another, are dependent on the enterprise in the State in which the fixed place is located (OECD 2019).

A permanent establishment is described by a tax treaty using the following two general tests:

- If the organization has a permanent place of business in the stipulated country, as specified by the treaty's language.

- If the company works in the desired country by a dependent person who regularly utlizes authority to enter into contracts on the corporation's behalf in the country (Bakertilly 2019).

The following categories of physical sites are considered to be fixed places of operation:

- Place of management
- Branch or an office
- Factory
- Workshop

A mine, oil, or gas well, quarry, or any other place where natural resources are extracted

The current idea of a permanent establishment, as explained in the OECD Model Agreement and the BEPS project, mandates some underlying changes, including another structure for a perpetual foundation limit. Practically all assessment arrangements presently in power incorporate the idea of a permanent establishment and are utilized to explain charge rights for cross-line organizations. Tragically, there is no enduring basic situation on this idea globally, nor is it in every case clear about their translation (Pistone, P. 2012).

Various options have been proposed, large numbers of these recommendations highlight a causal methodology, as per which a huge monetary presence is conclusive with respect to whether the option to tax exists. Some contend that producing turnover alone is adequate in certain nations. Some of the reasons states need the concept of permanent establishments can be explained in the explained in sub topics below.

Boosting Revenue

Permanent establishment taxes is another source of revenue for states as the business activities happens within the state jurisdiction (Skaar, 2020). If the permanent establishment is not established businesses will not pay taxes on their activities and will be a loss to the state.

Jurisdiction

Permanent establishment was created to estsblish jurisiction over a foreign business for business activities that generate income in the territory or state. Permanent establishment is used mainly as modern tax treaties instrument in establishing a jurisdiction over a non residence unincorpaorated business dealings (Skaar, 2020). The profit earned by a foreign company can only be charged if the activities happen in the area and there is a permanent establishment present.

Economic Significance

The present tax systems charges income at source by using fixed establishment concept and this includes the presence of a permanent establishment in the country and this gives a legal path for the organization to be taxed. It is ncessary for tax authority check if non-residence busniness through its activities has to be charged in the territory or not. The tax collected constitutes additional revenue for states apart from regular tax collcted from other legal entities, the revenue are used by the government in developing the economy.

1.5 Permanent Establishment and Taxation in Estonia

Information regarding a permanent establishment is provided in the OECD Model Convention, Estonian tax treaties and Estonian law. A permanent establishment refers to if a foreign company has a place of business in Estonia, Estonia has the legal right to charge its activities through a permanent establishment. (Skaar 1991). According to Emta (2019), permanent establishment companies are established based on outcome of location or type of business activities in Estonia, or as an outcome of business activities of a representative given permission to perform business dealings in the name of a non-resident in Estonia.

1.5.1 Establishing Permanent Establishment in Estonia

The legal attributes of a permanent establishment are contained in the Income Tax Act . § 7 of the act clarified that a permanent establishment can be referred to as an entity by which a non resident conducts a permanent business activity in Estonia. It arises as a result. It ussually happen based on outcome of location or type of business activities in Estonia, or as an outcome of business activities of a representative given permission to perform business dealings in the name of a non-resident in Estonia.

1.5.2 Taxation of Permanent Establishment in Estonia

One of the deciding factor for a permanent establishment is to have a business activity. Business activity presumes workers at the establishment, but a permanent establishment does not necesessarily require workers to operate equipments.

According to information on Tax and Customs Board site relating to treaties, a permament establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on (Emta, Taxation of profits in Estonia 2019).

§7 (3) of the Income Tax Act states that when a non resident conducts business activities in Estonia by means of a permanent establishment, the income anticipated to earn through its activities as a permanent establishment if it was another tax payer conducting the same or similar business activities shall be attributed to it. Tax liability arises for a non resident if income generated through the activities of the permanent establishments are deducted from the permanent establishment. Expenses and revenue are considered when computing income. According to tax treaties and Income Tax Act, the right to charge profits generated through permanent establishment activities in Estonia arises for non-resident legal person who resides in Estonia when profits are distributed. The retained earning of a permanent establishment are not taxed during taxation.

If a non-resident is a citizen of a nation with which Estonia has signed an international treaty for the averting of double taxation and the avoidance of fiscal evasion in the areas of revenue and capital taxes, tax concessions and incentives are available to them.
The revenue from a non-business resident's activities that is not covered elsewhere in the tax treaty may only be taxed in Estonia if the non-business resident's activities are conducted through a permanent establishment located in Estonia, according to the tax treaties.

The tax treaty prohibits, a non-resident who has not created a permanent place of business to be taxed under subsection 53 (4) of the Income Tax Act. The expenditures incurred in connection with the permanent establishment, including expenses incurred in connection with management and administration, are included in deciding the profits of a permanent establishment, regardless of the country in which the fees were incurred, may be deducted.

The terms of the tax treaty, according to Estonian law, have no bearing on the duty to register a permanent establishment. A non-resident legal person is not taxed via a permanent establishment in Estonia if the funds are used in the permanent establishment's real operations.

Income Tax Act 53 (4) instructs that in calculating the tax of a permanent establishment it must be centered on the fair rate of the transaction value. If an entity who is not an Estonian resident through its permanent establishment purchase goods made by its principal office, the reason for the purchase must be known, if its for personal use or resale, the cost price should be ascertained.

A permanent establishment is obliged to announce a taxable profit distribution under section 53 (4) of the Income Tax Act by means of a permanent establishment situated in Estonia for the duration of the tax period when the permanent establishment cannot utilize or receive income on another basis. If the non-resident cannot demonstrate that the matching share of the profit is available to him/her, the profit is deemed to have been moved. If the contract is terminated, the profit is deeemed distributed, and income tax is due.

1.6 Comparison of A Legal Entity and Permanent Establishments

Legal entities and permanent establishments have some similarities but also certain distictions which helps in understanding each concept. The comparism below will assist in understanding a legal entity and permanent establishments, this will serve as analysis in answering research question 1 : **are permanent establishments a legal, semi legal or non-legal person?**

According to article 5 of the OECD, permanent establishment is a fixed place of business through which business of an enterprise is carried our partly or wholly (OECD 2019). This definition points to the fact that there must be some sort of permanence to the location and carrying out business wholly or partly is a requirement. This shows some sort of activity must be done at the location and the activity is tied to an individual, property or machinery of the foreign company.
On the other hand a legal entity is defined as companies, institutions and organizations that are recognised to possess a legal rights and responsibilities as a person which includes preparing and submitting taxes (McMenemy, 2020). Legal persons are recognised by law as a person and given rights as an individual to enter in contracts and perform them. They can sue and be sued in the court of law.

The theoritical anaylsis of the definition shows permanent establishments are fixed place of business where the activities of the company is carried out in a foreign land different from the country of origin. It is mainly cerated to justfiy tax liablity as the revenue authority will make a claim on the activities within their territoty. While legal entities are registered in their usual country of origin within local laws and regulations. This definition shows that permanent establishments are not a legal entity but still recognised by the host country for taxation purposes.

Permanent establisments are created to support a head office or supplement activities of another main company. They are created outside of their usual country of origin and are seen as a foreign establishment carrying on business activities through its country of residence.
Legal entities are usually registered in the country of origin to be recognised as a legal person in carrying out its duties and obligations. They are recognised directly by the government through registreation as they would be citizens or usual residents of the country.

The theoritical anaylsis of the purpose and relevance of creation shows that permanent establishments are not legal entities as they arise through activities in another country of residence which is not the same as the head or parent company. As legal entities are established in the country of origin through local tax laws and regulations.

According to article 7 of the OECD, permanent establishments are utilized in, double taxation, and applies to a business of one state which has a permanent establishment in another state. The presence of a permanent establishment in a tax locality decides the privilege of the area to tax the income of the permanent establishment (OECD, 2008). States uses permanent establishment to establish jurisdiction and determine tax liability for non-residence business carrying out its activities through their locality.
Legal entities are established to have rights and obligations to trade, enter in business contracts in the country they are located (McMenemy, 2020). Tax liability arises from the relevant tax law of the country of origin through its activities during the accounting period. Jurisdiction is already established from inception as they are registered directed by law in the country of origin.

The theoritical anaylsis of the capacity of permanent establishments shows it is used mainly for international taxation which arise in a foreign nation. As tax authorities will like to have some revenue from the activities conducted from their territory, there is a need for the permanent establishment concept even though it does not have full legal entities status. This makes permanent establishment in my opinion a semi legal entity as it is recognised by the foreign government in some capacity.

Permanent establishment arises out of the need to establish a tax jurisdiction over activities of a non resident business within a locality. Permanent establishment activity in the area might be through subsidiary, dependent agent or broker who trades on behalf of the head office. Permanent establishment do not have a legal personality that enable them to engage in economic activities, enter contracts, have duties and obligations directly without the head office. They carry their business through a location associated with another entity.
Legal entities have personalities that enable them to engage in economic activities, enter contacts, have duties and obligations. To be a legal person is to be the subject of rights and duties (Salmond 1911). Legal personality is the capacity for legal relations. The personality gives them leverage and disposition to conduct business independently as they are fully recognized by law as an individual who can enter into contractual obligations.

The theoretical analysis of permanent establishments legal personality shows it is not a legal person as they lack the legal personality to enter contracts, have duties ad obligations directly without the head office. This shows some limitation which a legal entity would not have and shows their status is not a legal entity.

Permanent establishments assets are legally owned by the head office through which it operates or if it designated as economically owned (OECD 2006). The designation relies on the type of asset and how is being used. In determining the tax liability of a permanent establishment, it is the economic ownership or activities that is take into consideration. Charging depreciation or rents on assets depends if the asset is given economic ownership or treated as an asset of the head office. Asset partitioning with permanent establish is quite tricky or less possible as the asset are legally owned by the head office which makes claims against it in another country a huge task. It is quite possible in separating assets of the managers and beneficiaries from the permanent establishment, but affirmative and defensive asset partitioning is less possible.
Legal entities assets on the other hand, are fully owned since acquisition and once a pool of asset is created, it separates it from managers and beneficiaries. Creditors can be assigned to have a cliam against the pool based on their preference.

The theoretical analysis of assets of permanent establishments shows legally the assets belongs to the head office and this shows limitations. Although permanent establihments can economically own the assets but that prevents or limits asset partitioning and claims against such asset in a foreign country can be a huge task. This also shows permanent establishment do not have full legal status.

Furthermore, another difference between a legal entity and a permanent establishment is that a legal entity may enter into a legally binding arrangement to guarantee the debts of another entity, and third-party lenders may consider that guarantee when determining the entity's creditworthiness. For such a guarantee to be credible, the resources required to cover the assumed risks will have to be held in a different business from the one where the risk of default exists. One of the main factual requirements of a permanent establishment, on the other hand, is that capital and risks are not separated within a single legal entity. There is no reason for guarantee payments if capital is not separated.

Based on historical and academic analysis, permanent establishments are treated as a legal entity in determining tax liabiity from the activities performed within a tax jurisdiction of a state outside the country of origin. However, they are not a legal entity as they do not fully possess the charactristics of a legal entity. The author has shed more light in understanding the concept of legal entity and permanent establishments. They can be seen as a semi – legal entity as the status vary based on the purpose and application.

2. FINANCIAL STATEMENTS DEFINITION

Financial statements are summaries of a firm 's operating, capital, and investing activities (Pamela, Frank 1999). Financial statements can provide facts helpful to both stakeholders and creditors in making credit, acquisition and other business decisions.

Financial statements are a standardized representation of a company's financial position and performance. Financial statements have the goal of providing information about an entity's financial position, financial performance, and cash flows that can be used by a variety of customers to make economic decisions. The financial statements also illustrate the outcomes of management's efforts stewardship of the entrusted resources (IAS 1).

Financial Statements are a formal record of an entity's financial operations (Ali, 2020). Written reports that calculate a company's financial strength, performance, and liquidity. The financial impact of company deals and events on the entity are reflected in financial statements.

Accountants arrange, track, and record all of a company's financial transactions (Griffin, 2017). They prepare financial statements that convey a company's methodically recorded financial status at the end of each cycle or accounting period, such as a quarter or fiscal year.

A financial statement is a compilation of a company's financial activity and records (Bragg, 2020). This entails a budget overview from a collection of normative reports, as well as a cash flow statement, balance sheet, statement of retained profit, and revenue statement.

2.1 Objectives of Financial Statements

The intent of a corporation's periodic financial statements is to provide information that is needed to make reliable decisions. To do this, it is necessary to understand the origin and expiration of a company's economic resources, as well as the resulting changes in the interests of its creditors and investors. (AAA 1941, p. 134)

Accounting statements detail corporate management's accountability for property entrusted to them by third parties, as well as their responsibility for the proper use of money borrowed under a liability, as well as the expenses incurred and dividends declared. Accounting data is also used to calculate government revenue, such as property taxes, excise taxes, and income taxes. Accounting is unquestionably an essential mode of communication in today's industrial society. Accounting data must be skillfully compressed from a mass of facts to serve this purpose; it must be consistently truthful, insightful, and credible. (Littleton 1953, p. 15)

According to Casta and Ramond (2016), the objective behind financial statements, its importance and the value is to encourage the chance for several assessments of the efficiency of the organisation performance.

The objective of financial statement is to give data that will be helpful in settling economic assessments. These statements consider the output of relevant information as opposed to the process of accounting. This fundamental objective requires that each standard, guideline, method, practice and accounting objectives should serve the client’s requirements

2.2 Users of Financial Statements and Disclosures Needed

The Framework for the Preparation and Presentation of Financial Statements identifies seven types of financial statement users (investors, employers and organizations that represent them, lenders and vendors, clients, governments and their agencies, and the general public), as well as their information requirements (Luca, 2008).

The internal users of financial information are represented by an organization's managers, who can be classified into the following categories based on the general characteristics of the obligations to be fulfilled namely top managers, middle managers, first-line managers or supervisors.
Users from outside the company (External users) and their information requirements. The financial statements are a vital tool for communicating accounting information to decision-makers. These are often the only sources of information accessible directly from the company for users outside the group.

Investors (shareholders, associates), employees, lenders, suppliers customers, and governments are mainly the external users of financial statement. Governments and their agencies play a dual role: on the one hand, as accounting authorities, and on the other hand, as users of the financial statements' information (Luca, 2008). The state, as a user, requires information mainly for fiscal purposes, such as determining the tax base and ensuring that taxpayers pay their taxes on time.

Financial statement disclosures provide additional information about a company's financial activities to internal and external business stakeholders. Generally agreed accounting principles may require disclosures, or management may choose to make them voluntarily (Vitez, 2017). The disclosures needed should include how the financial statemnent were prepared and any changes to procedures.

2.3 Types of Financial Statements

As financial statement shows the financial position of an entity, it is important to understand the various types of financial statement available. The balance sheet, income statement, statement of cash flows, and statement of equity are the four basic financial statements (Pamela, Frank 1999). The major types of financial statement prepared by entities are :

1. Balance sheet
2. Income statement
3. Statement of cash flow
4. Statement of Equity

Balance Sheet

Balance sheet is a summary of the assets, liabilities and equity of a business at a particular point in time. It is also known as statement of financial condition or position (Pamela, Frank 1999). Balance sheet are usually prepared for an accounting period (1 year) i.e January 1st 2021 to December 31st 2021. The values reported on the balance sheet are not current market value but represent an historical cost.

The content of each side of the balance sheet will be discussed further under analysis as we will be concentrating more on the balance sheet of legal entities and permanent establishments later.

Income Statement

An income statement is a list of a company's revenues and costs for a specific time span (Pamela, Frank 1999). This is also known as the profit and loss declaration. It depicts the outcomes of the firm's operational and financing decisions during that time frame. An income statement records the revenue generated through business activities and deduct costs used in generating the revenue for the business. The income statement of permanent establishments and legal entities are similar and no major chnages in the procedures. Basically, recording of trading activities follows the same accounting procedure as there will be revenue generated, cost incurred and the difference would be a net income or loss. The author will not be looking deeply into this as the ineretest is in pointing out differenes and not similarities regarding how financial statements are prepared.

Statement of Cash Flows

The statement of cash flows, is a financial statement that summarizes the amount of cash and cash equivalents entering and exiting a company (Murphy, 2001). The cash flow statement assesses a company's ability to handle its cash balance, or how well it raises cash to pay debt commitments and cover operating expenses.

A cash flow statement shows how often money is coming in and going out of the company (Warnes, 2019). It's one of the three major financial statements for handling your small business accounting and ensuring you have enough cash to stay going, alongside balance sheets and income statements. The cashflow statement of permanent establishments and legal entities are similar and no major chnages in the procedures. Basically, cash coming in and out through trading activities will be recorderd following the same accounting procedure. The author will not be looking deeply into this as well, the ineretest is in pointing out differenes and not similarities regarding how financial statements are prepared.

Statement of Equity

The owner's stake in the firm is referred to as equity. The ownership of a company is expressed by common stock and preferred stock (Pamela, Frank 1999). The owner's equity statement is a financial statement that shows how the equity portion of the balance sheet has changed over time. To put it another way, it records the activities that raised or reduced stockholders' equity during the accounting cycle (Pamela, Frank 1999). A Statement of Owner's Equity displays adjustments in the capital account as a result of contributions, deductions, and net profits or loss. Permanent establishments do not have equity and as such no statements are prepared to show movements. The author will not be looking deeply into this as no such statemrnt exist for permanent establishments.

2.4 Preparing Financial Statements of a Legal Entity

The author intends to concentrate on balance sheet and it's content for this thesis. Legal entities are required to prepare financial statements which shows the financial position of the company. The statement also helps creditors, governement, shareholders etc to understand how viable the company is and continued interest in investing in the company. The statements prepared includes balance sheet, cash flow statements, income statement and statement of equity.

Balance sheet shows the financial position of the company at certain point. The usual balance sheet formula is Asset = Liabilities + Equity. The first part of the balance sheet or as it is referred to debit side shows the asset which is also sub divided into fixed, current, non fixed or intangible will be discussed further.

International financial reporting standard (IFRS) defines asset "An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise." An asset represents property or items which a company owns and utilisies in the running of the business. They contribute to the overall activities of the busniess and integral in production, distribution and creation of revenue.

Assets can be classified into fixed and current asset. Fixed asset can be sub divided into tangible and intangible assets. Fixed asset are property which has a long life and use in production or generating revenue for the business. They usually are not disposed off within a year and depreciation is usually charged on the asset as they cannot be converted to cash easily. Examples of fixed assets are plant and equipment, building, furniture and fixtures etc.
Tangible assets are physical items of the company which are used in generating revenue for the company. They are asset which includes equipment, building and vehicles.
Intangible assets are assets of the company which cannot be seen pyhsically and have monetary value. They include patents, copyrights, goodwill etc

Current assets are assets of the company can be easily coverted to cash through the activities of the business within an accounting period. They are used within a year and shows how liquid a business can be in meeting its obligations. Current asset includes cash, account receiveables, prepayment, inventory etc.

The second part of the balance sheet or as it is refered to is the credit side which shows the liablities and equity. The is sub divided into current, long term liabilities and equitiy.
Current liabilities are short term obligations of the company that are meant to be settled within the accounting period which usually is a year. This includes rent, account payable, interest payble, aaccrued expenses etc.

Long term liabilities are obligations of the company that needs to be settled and usually last more than a year. This includes long term loan, bonds paybale and finance leases.
Equity represents ownership of the company, it represents the difference between assets and liabilitiies of the company. This can also represent the value of shares issued by the company to raise capital in the form of ordinary or preference shares. This also shows how the company is financed and through which means its capital is secured. This is a core concept which shows ownership and asset of a company can be separated from personal use.

Equity concept will be used in analysing the major difference between an entity and permanent establishment in terms of ownership, capital formation and capital structure.

2.5 Permanent Establishment Financial Statements

The author aims to analyse how financial statements of permanent establishments are prepared and the analysis will be limited to balance sheet.
According to OECD (*Scope of the globe rules* 2020), a permanent establishment is treated as a separate entity, if it has separate financial statements for financial reporting, regulatory, tax reporting, or internal management control purposes. It ensures that income earned through permanent establishments in another jurisdiction is not combined with income earned by the head office in another jurisdiction.

If no applicable tax treaty exists, a permanent establishment is considered to exist in a jurisdiction if it has a proper business presence in that jurisdiction and the operations' revenue is taxed on a net basis under the applicable domestic legislation.

A non-resident legal entity with a permanent establishment in Estonia is obliged to send a signed copy of its permanent establishment's annual report to the Tax and Customs Board within six months of the end of the financial year, according to Section 55 (2) of the Income Tax Act. According to Subsection 57 (3) of the Taxation Act, the keeping of accounts and accounting for taxation purposes must be organized in such a way that an overview of the conduct of transactions and of facts important for taxation purposes can be achieved in a reasonable amount of time.

Despite the absence of separate accounting rules for permanent establishments, a non-resident must maintain the permanent establishment's accounting for taxation purposes in such a way that it is possible to achieve a fair overview of the costs incurred, income gained, and assets and liabilities of the permanent establishment located in Estonia within a reasonable period. A management report, balance sheet, and income statement are normally included with the report (Leinonen, 2014). It is not necessary to have the report audited.

The author has analysed that permanent establishments are treated as a legal person when determining tax laiblity even though they are not fully a legal person and as such can be regarded as a semi-legal entity. The status vary based on application and the author intends to take a look at the financial statement prepared for the tax authority focusing on balance sheet.

2.5.1 Preparing Permanent Establishments Statement

The author aims to analyse how balance sheet statement of permanent establishment are prepared despite not having a full legal entity status. This presents some sort of challenge as there no separate set of accounting procedures for permanent establishment, yet they have to submit statement of financial position for tax purposes.

Article 7(2) gives an insight when preparing balance sheet of a permanent establishment, it is important to understand and analyze to assess the degree to which the enterprise's properties (tangible or intangible) are economically owned by and/or used in the duties engaged by the permanent establishment.

The approved OECD approach's (OECD 2006) first move not only specifies the properties used by the permanent establishment, but also the circumstances under which they are used: as joint or sole owners. Ascertaining ownership of a permanent establishment's properties can be difficult, unlike in different entities where legal agreements can be depended on to decide ownership.

In a permanent establishment background, the enterprise's assets legally belong to the entity of which the permanent establishment is a part. To assign economic ownership of assets to a permanent establishment under the first step of the authorized approach, the concept of "economic ownership" must be introduced.
Economic (rather than legal) conditions are more relevant in deciding the characteristics of the permanent establishment for taxation purposes since they are more likely to have a greater impact on the economic relationships between the different sections of the single legal entity.

Economic ownership of an asset is measured by a practical and factual review, which is based in part on the performance of the key people functions involved in ownership of the asset.
The outcome of assigning economic ownership of assets in the first step for calculating income in the second step may vary depending on the type of asset and the type of business where it is used. The effects of attributing assets to the permanent establishment in the first step of the OECD-approved approach for calculating profits in the second step are dependent on the circumstances, especially the nature of the company and the asset, and if the significant people functions related to determining economic ownership of assets are the same as the significant people functions related to business risk inference.

In general balance sheet shows asset equals liabilities plus equity, for a permanent establishment there are some certain differences owing to the fact that they do not have a full entity status. The authorized approach for preparing and stating assets, liabilities and capital are discussed below:

Tangible Assets
According to When a permanent establishment is regarded as the economic owner of a tangible asset, it is usually entitled to depreciation (for depreciable assets) and interest deductions (in the case where the asset is wholly or partly debt-financed).
When a PE is regarded as the lessee of a tangible asset, it is usually entitled to rent-related deductions.

In fact, the permissible deductions in the two cases do not vary substantially over the asset's useful life, but the two cases may result in somewhat different benefit allocations in any given year or period of years.

Intangible Assets

The handling of intangible property, which separates marketing intangibles from other commercial intangibles (referred to as "trade" intangibles) and could be extended to permanent establishments by comparison. The definition of functional and factual analysis would be used in particular to assess which, if any, parts of the enterprise were responsible for producing the intangible.

Clearly, determining the economic ownership of intangible property generated by an enterprise should be focused on principled grounds in order to rule out the possibility of the enterprise merely designating one portion of the enterprise as the owner (by booking the intangible assets there), regardless of whether the intangible assets are actually created by the enterprise. As intangible assets are not easily identified like tangible assets this sometimes presents some issues when permanent establishment and head office uses the same or both benefit from the asset.

Capital

According to report on the attribution of profits to permanent establishments (OECD 2006), free capital is an investment that does not generate an investment return in the form of interest that is deductible for tax purposes under the laws of the permanent establishment's host country. According to authorised OECD approach (OECD 2006), the permanent establishment is considered to have sufficient resources to finance the roles it performs, the assets it uses, and the risks it takes.

Risks are assigned to a permanent establishment based on where the significant people functions linked to the estimation and/or management of the risks are performed, and economic ownership of assets is attributed to a permanent establishment based on where the significant people functions relevant to the assessment of economic ownership are performed (OECD 2006).

Assigning an arm's length amount of income to the permanent establishment is to decide how much of the enterprise's "free" capital is required to cover those assets and sustain the risks assumed after the practical and factual analysis has assigned the relevant assets and risks to the permanent establishment.

In the first part of this thesis, the author was able to analyse reports, articles, journals, books etc This has shown that permanent establishment are different from a legal entity but have certain similarities. They can be classified to be a semi legal entity and this is also shown in the way the balance sheet is prepared as well.

This can allow the author to answer the second research question below:

How are financial statements of permanent establishments prepared based on their status?
Balance sheet statement of a permanent establishment seems a bit complicated from usual legal entity statement as legally asset of a permament establishment legally belongs to the head office. To resolve this, a term economic ownership has to be created to represent the economic activities performed by the permanent establishment and through that tax liability can be ascertained.

A legal entity shows asset equals liabilities plus equity but for a permanent establishment there is no equity. This represent a major difference as equity shows ownership structure of a company and structure of financing. The term free capital was created to cover the equity side of the balance sheet which simply covers the risk associated with the activities of the permanent establishment. However, the term free capital has not resolved equity as some permanent establishments do not allocate such funds which can affect the balance sheet equation (Assets = Liablities + Equity). The tax authority are not really interested in capital, equity or free capital but activities that generate revenue and amount of tax due.

According to report on the attribution of profits to permanent establishments (OECD 2006) member countries have agreed on the principle that a permanent establishment should have enough free capital to cover the functions, properties, and risks it takes on, but it has not been possible to establish a single globally accepted approach for allocating the requisite free capital under the authorised approach. The OECD assumed that when drawing the permanent establishment's balance sheet, the head office country would use the same capital structure as the host country. However, this has rarely been the case since, because permanent establishment profits are calculated based on domestic tax laws, it is almost impossible for head office and host countries to arrive at the same permanent establishment profits. Furthermore, if the credit scheme is used under Article 23 of a tax treaty, unrelieved double taxation is likely to occur.

Based on the issue above, the author believes the best system will be to create international accounting rules rather than implementing the authorised approach. This system will benefit both head office and host countries in a lot of ways. In situations when nothin is allocated as free capital to cover risk and activities of the permanent, the author believes that a balancing number or a difference between the assets and liabilities can be applied to equate the balance sheet equation. As no separate accounting rule has been established to regaulate how the financial statements of permanent establishments, the author's proposal can be considered. The balancing number or difference between the balance sheet equation will be included under disclosures to show how it is derived as disclosures are necessary to show tranaparency and method used in preparing the balance sheet.

Firstly, this choice does not necessitate modifying the tax treaty network, which is a significant undertaking in the decentralized system of international taxation. Secondly, the issue will not be one of consensus, but rather of accounting synchronisation between the head office and the permanent establishment. Lastly, establishing international accounting rules for attributing free capital to permanent establishment could become a suitable option to the authorized approach, since both the head office and the permanent establishment will be required to prepare such paperwork, lowering the risk of controversies arising from their dealings

CONCLUSION

The aim of this bachelor thesis is to find out if permanent establishments are legal, semi legal or non legal entity and analyse how financial statements are prepared based on the status. There is a desire to know the effect the legal status of permanent establishment has on preparing financial statements submitted to the tax authority as they engage in business dealings in their base of operation.
Legal enties are required to submit financial statements to show their financial position at a particular point in time, the statements are needed by shareholders, creditors, investors and government agencies to determine tax liability. As permanent establishments arise based on business activities in a foreign place of residence other than origin of the company, separate rules apply when determining the tax liabilities. A permanent establishment is used to tax a non-resident corporation, giving the state the legal right to do so, to impose a levy.

The first research question was "Are permanent establishment a legal, semi legal or non legal person?" Permanent establishments have certain distinctions that separates them from legal entities, even though there are some similarities in area of international taxation. Permanent establishment arise based on activities of an entity in foreign country other than the country of origin, this allows the tax authority of the state to tax them. The creation helps in dealing with international taxation.
Consequently, one of the principal distinctions between a legal entity and a permanent establishment is that a legal entity can engage into a legally binding contract to pledge the debts of a separate entity, and third-party creditors may take that pledge into account when assessing the separate enterprise's creditworthiness. Based on analysis of articles, books, journals and relevant conventions of OECD, permanent establishment can be regarded as a semi legal entity as they do not fully have the characteristics of a legal entity in terms of legal personality, asset partition and creation.

The second research question was “How are financial statements of permanent establishments prepared based on their status?” As the author has made conclusion that permanent establishment cannot be regarded as a legal entity , it is obvious that this will affect how financial statements are prepared and submitted to the tax authority. Financial statemens show the financial position of the company at a particular point in time. The analysis was limited to the balance sheet and the usual formula for it shows asset = liabilities + equity. Equity represents ownership of an entity comprised of shareholders fund and debt finance but as permanent establishment are not legal entity they cannot have equity which makes preparing their balance sheet a bit complicated.

Legally assets of permanent establishments belong to the head office and to prepare balance sheet to determine the tax liability , assets have to be given economic ownership as it is the economic activities that gives rise to a permanent establishment in a foreign state. Equity is replaced with the term free capital which covers the risk associated with the activities of the permanent establishment but the interpretation of the term varies widely across countries and with some not allocating the funds. This can affect the balance sheet equation and there is a need to allocate a balancing number or simply the difference between the asset and liabilities for equity. Legal entities have procedures widely accepted procedures and approach when preparing statements and this can be emulated by the permanent establishments as well. A general and accepted procedure like having a balancing number or simply tye difference of assets and libalities to equate the balance sheet, can be created that must be strictly followed when preparing balance sheet of permanent establishment especially in the area of allocating free capital which is fair to states and business. A unified approach can prevent bias or fraud when preparing the required statements.

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