

# Latvian case law on taxation 2/6/23



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This article offers a short summary of the latest case law on personal income tax (PIT).

## Charging PIT on income not received

The Supreme Court has ruled<sup>1</sup> that if the parties to a contract for the sale of real estate (RE) agree that the purchase price will be paid by instalments over several years, but they enter into a cancellation agreement before the first instalment is paid, then the seller is not liable to pay PIT.

The State Revenue Service (SRS) claimed that the seller must pay PIT on the entire transaction amount. Specifically, the SRS invoked a piece of legislation that imposes this obligation where the taxpayer receives proceeds from the sale over more than three tax periods, because the total income is considered to be gained in the first three tax periods. So the SRS claimed that the income must be reported and taxed, even though no income was actually received.

However, the Supreme Court found that the meaning and purpose of the tax laws dictate that tax be charged on the person's income they actually gain in the relevant tax period or periods. If the person has not gained the expected income and no longer stands to gain it, the obligation to pay tax has no legal basis. This applies also to cases where it is found that the sale has been cancelled and will not be completed.

By analogy the Supreme Court invoked a clause in the PIT Act stating that if the transaction is not completed as expected, then a capital gain is any income which the taxpayer has received and is not required to pay back. The opposite view that tax is payable even though the person has not gained any income and will not gain it in the future is unfair and obviously contrary to the essence of PIT.

## PIT on income from RE sold during insolvency proceedings

In December 2022 the Administrative Division of the Supreme Court heard a dispute<sup>2</sup> over whether the taxpayer is liable to pay capital gains tax on income arising on the sale of RE during insolvency proceedings.

In this case the insolvency administrator sold seven plots of land owned by the taxpayer. The SRS's decision requires the claimant to pay PIT and a late fee charged on income arising on the sale of RE during insolvency proceedings. The taxpayer disagreed with this decision and believed that PIT was not payable because he actually received no income from the sale of RE during insolvency proceedings but only suffered a loss, i.e. he lost the RE.

In its ruling the Supreme Court invoked a provision of law stating that income arising on the sale of RE during insolvency proceedings is subject to PIT – capital gains tax. The lawmaker has made no exception where the taxpayer should be exempted from PIT on income arising on the sale of RE during insolvency proceedings. Moreover, only the person's statutory expenses should be considered in determining taxable income. So, the manner in which the income is spent and whether it is applied to cover the costs of

insolvency proceedings or debts cannot affect the procedure for determining taxable income.

Yet in examining the question of what funds should be applied to pay capital gains tax, the Supreme Court recognises that to the extent this affects capital gains tax on income arising on the sale of RE during insolvency proceedings, the text of the law is contrary to the lawmaker's plan and leads to an unfair settlement of the situation. The Supreme Court states that capital gains tax is essentially consistent with the nature of direct costs of insolvency proceedings, so this should be covered out of the proceeds from selling the RE. The Supreme Court also points out that normally, even though capital gains tax can be paid out of any funds, the taxpayer can expect to use the income arising on the sale of RE to carry out the obligation to pay tax. The Supreme Court sees no grounds for treating this case differently only because the sale of RE occurs during insolvency proceedings. The existence of insolvency proceedings should not prevent the debtor from settling his tax liability out of the income that created it. In other words, capital gains tax on income arising on the sale of RE during bankruptcy proceedings would be payable on the same income.

At the same time, the Supreme Court recognises that the fact that capital gains tax was not paid out of the proceeds from selling the debtor's property cannot serve as a basis for the debtor being released from the obligation to pay tax. During insolvency proceedings, the debtor has to properly cooperate with the administrator and inform him of any capital gains tax due, its amount and the need to cover these costs out of the proceeds from selling the debtor's property.

It's important to note that amendments to the PIT Act effective from 1 January 2023 will exempt income arising on the sale of a capital asset during an individual's insolvency proceedings if he is released from his obligations under section 164 of the Insolvency Act. This rule will apply to capital assets that are sold during an individual's insolvency proceedings after the amendments come into force. Such income is treated as gained the day on which the court made the decision to terminate the insolvency proceedings.

However, these amendments do not affect the Supreme Court's finding that a capital gain arising on the sale of an asset during insolvency proceedings is taxable per se.

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<sup>1</sup>Ruling SKA-198/2022

<sup>2</sup>Ruling SKA-45/2022