

Tax laws must be clear enough especially with liability for tax offences (2/12/20)

Although the State Revenue Service ("SRS") has already changed their approach to the VAT treatment of prematurely terminated finance leases for second-hand vehicles, this article explores some of the findings made by the Supreme Court's Administrative Division in its ruling of 10 April 2019 (case No. A420404414, SKA-54/2019) which can help us determine the VAT treatment in other situations.

The legal framework

Both the old VAT Act (repealed from 1 January 2013) and the current VAT Act provide for treating a finance lease as a supply of goods. And a transaction becomes a finance lease if the lessor and the lessee have agreed that title to the asset will pass to the lessee after he makes all the agreed payments. This is what distinguishes a finance lease from an operating lease, as under section 2112 of the Civil Code an operating lease is a contract whereby one party gives or promises the use of an asset to the other party in exchange for rent.

A finance lease of a second-hand asset is eligible for the VAT margin scheme for second-hand goods, with VAT being only charged on the difference between the acquisition cost and the selling price.

If the lessee defaults on the finance lease, as happened in the case being heard, then title to the asset will not pass to the lessee. The SRS finds that in this situation a supply of goods did not take place so the transaction should have been reclassified as an operating lease, especially because an operating lease attracts a higher amount of VAT (all the payments being taxable) than what is paid on a finance lease under the VAT margin scheme for second-hand goods. The SRS claimed that this scheme is applicable under Latvian law to terminated finance leases of second-hand real estate ("RE") so the same principle should be followed when terminating a finance lease of a second-hand vehicle.

The Supreme Court finds that paragraph 161 of the Cabinet of Ministers' Rule No. 933 of 14 November 2006 (repealed from 1 January 2013) provides that if a finance lease terminates prematurely, the lessor must issue a credit note to the lessee for the outstanding portion of the asset. This rule specifies the action to be taken by the lessor in that situation. Neither the VAT Act nor the Cabinet Rule expressly requires that an invoice be issued for an operating lease where a finance lease of a second-hand vehicle terminates prematurely.

In hearing the case, the Supreme Court focused on the principle of legal certainty and legitimate expectations, which provides firstly that provisions of law must be clear and precise, and secondly that persons must have an opportunity to foresee their application. This principle is upheld by the case law of the Court of Justice of the European Union ("CJEU")¹ and is particularly important where the legal framework may involve financial costs being incurred to allow the interested parties to precisely know the extent of obligations imposed on them. Accordingly, taxpayers should know the extent of their tax liabilities before entering into a transaction.²

The Supreme Court has emphasised earlier that tax laws must be clear enough, especially where liability for tax offences is involved.³

The Supreme Court agrees with the taxpayer that section 10(4)(8) of the old VAT Act and section 32(7) of the current VAT Act, which provide that if the lessee defaults on a finance lease of second-hand RE and the lessor retains title, the supply becomes an operating lease and VAT is chargeable on all finance lease payments (other than loan interest payments) made earlier, apply only to finance leases of second-hand RE. Only with RE, if the lessee defaults on the finance lease and the lessor retains title, VAT is chargeable on all earlier finance lease payments as if the transaction were an operating lease from the outset, and the lessor must issue an invoice for an operating lease.

Because section 10(4)(8) of the old VAT Act, which applies directly to RE transactions, does not yield a general principle that would be applicable in other cases, the Supreme Court finds that the lessor in a finance lease of a second-hand vehicle is not required to reclassify it or to issue an invoice for an operating lease.

¹ CJEU 10 September 2009 ruling *Plantanol*, C-201/08, paragraph 46, and 9 October 2014 ruling *Traum EOOD*, C-492/13, paragraph 28

² CJEU 27 September 2007 ruling *Teleos et al*, C-409/04, paragraph 48, and 9 October 2014 ruling *Traum EOOD*, C-492/13, paragraph 29

³ Supreme Court 11 June 2011 ruling No. SKA-107 (A42656207), paragraph 15