PIT Act’s provisions for determining traders’ taxable income are unconstitutional 2/4/22

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

Irena Arbidane

On 7 January 2022 the Constitutional Court ruled on case No. 2021-06-01, in which the Ombudsman claimed provisions of the Personal Income Tax (PIT) Act for determining traders’ taxable income are inconsistent with section 105 of the Constitution. This article explores why those provisions were challenged and what the ruling found.

The contested provisions

Under the old PIT Act (before 2018) traders were not liable to pay tax if their expenses were equal to or higher than their revenue, that is, if no profit was made.

Effective from 1 January 2018 the PIT Act contains provisions that require traders to pay tax also if their business expenses are equal to or even higher than their revenue. These provisions in fact make traders pay tax if they do not make a profit. Here are the contested clauses:

- Section 11(3.1) provides that business expenses may be claimed up to 80% of the person’s total business revenue.
- Section 11.1(6.1) states that if the taxpayer’s taxable income is less than 20% of their business revenue after making adjustments prescribed by this section then tax will be charged on an amount no less than 20% of the business revenue.

Why were the clauses contested?

According to the court filing, by demanding that PIT be paid on unearned income, the contested provisions of the PIT Act unreasonably restrict traders’ basic rights defined in the first three sentences of section 105 of the Constitution: “Everyone has the right to property. Property must not be used against the public interest. Ownership may be restricted only in accordance with the law.”

The Ombudsman finds the contested provisions are unfair and contrary to the economic substance of PIT and they fail to achieve their legitimate aim of restricting the shadow economy. In the context of tax law it is fair for the State to demand a share of what the taxpayer has truly earned, not of some deemed income.

What the court found

The ruling states that the PIT charge must depend on the real income to ensure the financial burden the tax liability creates is reasonable. The ability to pay PIT must also be assessed in the light of the objective net principle, which states there must be an option to deduct business expenses in arriving at taxable income.

Taxing deemed income breaches the objective net principle, which provides that PIT is chargeable only on the taxpayer’s real income and not deemed income.

The Constitutional Court found the restriction on the right to property the contested provisions of the PIT Act impose is not based on objective and rational considerations aimed at upholding the principles of justice and legal equality. So the court found this restriction fails to achieve the legitimate aim of the contested provisions and they are inconsistent with the Constitution.