New precedent in charging payroll taxes on labour lease 1/21/23

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On 18 April 2023 the Supreme Court ruled on case No. A420131521 concerning the classification of non-business expenses for corporate income tax (CIT) purposes, application of the concept of labour lease, and additional taxes charged by the State Revenue Service (SRS) in the construction sector, where subcontracted labour was used.[1] By its ruling the Supreme Court refused the company's request for reversal of the SRS's decision, which remains unchanged and has taken effect. We feel MindLink subscribers should become familiar with this decision by which the SRS charged CIT and national social insurance (NSI) contributions, as well as a late fee and a penalty. For personal income tax (PIT) purposes, only a penalty was charged.

Background

A Latvian company ("X Ltd") entered into an agreement with another Latvian company ("Y Ltd") for construction services. To provide services, Y Ltd leased workers from its subcontractors in Lithuania and Poland. Y Ltd paid payroll taxes (PIT and NSI) for those workers based on a labour lease relationship.

During a tax audit, the SRS challenged the existence of the transaction specified in the agreement and found that Y Ltd did not provide construction services and did not lease workers to provide such services to X Ltd (using leased workers from abroad or its own employees). The SRS claimed that construction work was carried out by X Ltd using unknown workers without entering into an employment contract. So the SRS decided the transaction was a fictitious one, charged CIT on X Ltd for a fictitious transaction and NSI on the remuneration paid in an unregistered employment relationship, as well as charging a late fee and a penalty, including a PIT penalty.

The Supreme Court's ruling

It follows from the ruling that the transaction between X Ltd and Y Ltd was fictitious because its economic substance does not correspond to reality. The court found no evidence of construction services Y Ltd had allegedly rendered to the claimant. Despite the claimant's arguments, a labour lease relationship was not found to exist between the claimant and Y's leased workers, which could justify the claimant's failure to enter into a contract with the workers. The court finds there was no labour lease relationship between Y Ltd and the individuals working on the construction site because X Ltd hired individuals unrelated to Y Ltd or foreign companies by unlawfully refraining from entering into an employment contract with them. Moreover, there is no evidence that Y's leased workers carried out any work for the claimant. Based on these facts, the court upheld the SRS's decision to charge NSI for unregistered employment. However, the SRS and the court found that PIT is not due because the persons worked unofficially and no taxes were withheld from them, by interpreting the PIT Act's section 29(2) to mean that no tax may be paid to the government out of the employer's pocket unless it was withheld from the worker.

At the same time, the Supreme Court did not recognise X's expenses as business expenses because it's impossible to establish that Y Ltd provided services, so the expenses are chargeable to CIT. The court refuted the claimant's argument that the SRS's tax assessment restricts the claimant's freedom to use services rendered by citizens or companies of other member states. The court finds that the right to freely provide services across the EU does not mean that this right can be abused by employing persons without entering into an employment contract and without paying labour taxes.

Tax consultant's comment

Having evaluated the claimant's arguments regarding tax compliance, we believe it's possible to invoke article 15 of Latvia's double tax treaties (DTT) for a PIT exemption. Although the court dismissed this on the grounds that the claimant's staff were not working according to statutory requirements, which precludes the application of any DTT, the primary reason should be non-compliance with this clause. Specifically, this clause provides for taxation only in the person's country of residence and operates if a non-resident has worked for up to 183 days in any 12-month period and their legal or economic employer is not a resident of the country in which the actual employment takes place. In this situation the conditions are not met because X and Y are Latvian companies and the employees worked in Latvia for a longer period than the DTT limit. So DTTs cannot be used in this case.

A bit of confusion was caused by the court's arguments for not charging PIT based on an interpretation of the PIT Act's section 29. According to the materials of the case, this interpretation was provided by the SRS believing this section prohibits recovery from the employer of any unpaid PIT that was not withheld from the worker's remuneration earlier. The court accepted this argument. It's important to note that this interpretation reduces the amount of tax to be collected in this case and in fact opens up opportunities for employers paying cash in hand to evade PIT in other cases too.

If we are to properly evaluate the claimant's liability and the sufficiency of the SRS's evidence, we must consider the materials of all the judicial instances in detail. It's worth noting, however, that taxpayers must be able to prove their opinion based on relevant pieces of legislation and documentary evidence.

To raise awareness of differences between business trips, on-the-job travel, secondments and labour leases, and of the correct payroll tax treatment in each case, we recommend watching a video recording of PwC Academy's webinar "Comments on the taxation of employees moving to and from Latvia".

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[1] https://manas.tiesas.lv/eTiesasMvc/nolemumi/pdf/504390.pdf