Is solidarity tax in fact personal income tax? 3/16/24

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The peculiar procedure for calculating and paying solidarity tax (ST) often has taxpayers wondering about its link with other Latvian taxes: personal income tax (PIT) and mandatory national social insurance (NSI) contributions. Confusion about ST's essence and mechanism may lead to a dispute with the tax authority and even litigation. This article explores one of the latest cases heard by the Latvian Supreme Court regarding an ST payer's request for a refund of PIT wrongly paid by making ST payments in Latvia.

Background

On 28 February 2024 the Supreme Court passed Ruling A420280519 dismissing a Latvian individual's request for issuing a favourable administrative instrument that would require the State Revenue Service (SRS) to refund EUR 22,155.41 of PIT for 2018.

The request arose from the person doing work outside Latvia and making ST payments in Latvia. In 2018 he was posted to work in Croatia and Switzerland, and the two countries charged their national income tax on the employment income he earned there. He had taken out a Latvian A1 certificate before the posting, so NSI contributions were paid in Latvia. Since his total annual employment income exceeded EUR 55,000 (the NSI cap in 2018), he in fact paid not only NSI contributions but also ST under the rules in force at that time.

His claim was based on section 8.1(3) of the Solidarity Tax Act, which states that 10.5% of ST paid is credited to the Treasury's PIT distribution account, but section 1(3) of the PIT Act states that this portion of ST is included in the PIT paid. These clauses led the claimant to believe that paying Latvian ST meant he also paid PIT.

The person believed the payment of PIT (the portion of ST credited to the PIT account) was unlawful because he had already paid income tax in Croatia and Switzerland. And Latvia's effective double tax treaties (DTTs) with the two countries provide for paying PIT or an equivalent tax in one country only. On this basis he requested a PIT refund, but the SRS refused on the grounds that PIT had not been paid.

The dispute eventually landed in the Supreme Court, which expressed its opinion on the essence of the case.

The court opinion

Having evaluated the person's arguments, the Supreme Court agreed that 10.5% of ST goes into the Treasury's PIT distribution account to pay the portion of PIT charged after applying the top rate of 31.4% through the annual income tax return. However, the portion of ST used for payment of PIT does not become PIT because this is essentially a different tax charged and paid to the government through the mechanism for PIT and NSI contributions. The court emphasised that using ST to pay PIT is the lawmaker's choice to ensure the top rate of PIT is paid without putting the person to additional tax consequences

through the annual income tax return. In other words, the ST distribution does not alter the fact that PIT and ST are two different taxes.

The Supreme Court also stated that the portion of ST will be deducted from the taxpayer's allowable expenses because NSI contributions and ST are deducted from the taxable base as allowable expenses before PIT is calculated, but there are no grounds for deducting the ST from taxable income, as ST revenues are partially applied to pay PIT.

The court also refuted the claim that Latvia's DTTs with Croatia and Switzerland could exempt the person from ST. The court stated that ST was adopted after the DTTs were signed and the fact that Latvia has not announced an extension of the treaty rules by amending article 2, which identifies taxes covered by the DTT, means that the treaty relief does not extend to ST.

Key takeaways

Having examined the Supreme Court's opinion, we must agree with the position on the essential distinction between ST and PIT. These are two distinct taxes with different payment procedures and administration goals. Like PIT and NSI contributions, ST has a special revenue distribution procedure consistent with the Solidarity Tax Act's objectives.

The top rate of PIT was adopted when the ST distribution procedure was amended to balance the tax burden between ST payers and those who are not paying Latvian NSI contributions. ST aims to:

- Minimise tax regressivity for persons with higher income levels
- Generate revenues as part of the core national budget and municipal budgets for funding the growing need to provide social protections and reduce inequalities, including to finance health care services

So, 10% of ST going into PIT revenue as part of the national budget does not mean this portion of ST is converted into PIT, yet the mechanism provides a way to pay the person's PIT liability by applying the top rate.

Each tax has its own refund procedure, so this should be examined separately under the relevant tax law. The Solidarity Tax Act states that an ST refund is the difference between the ST paid during the tax period at the rate of NSI contributions and the ST charged at a rate of 25% when the annual income tax return is filed. Where NSI contributions are split between the worker and the employer, the overpaid ST is refunded only to the employer by 1 September in the following tax period. However, if the person himself paid the contributions in full, the National Social Insurance Agency will notify him of the overpaid ST by 31 July in the following year and request details for crediting the overpay to a bank account or a postal payment account.