

# What criteria do tax authorities and courts use in evaluating intermediary's role in cross-border transactions? 2/47/24



Consultant, Tax, PwC Latvia  
Aleksandrs Afanasjevs



Partner and Head of Tax Practice, PwC Latvia  
Ilze Rauza

On 30 September 2024 the Latvian Supreme Court issued Ruling No. A420226518 after hearing a Latvian company's appeal against a decision from the State Revenue Service (SRS) and a ruling from the Regional Administrative Court. The dispute was over the results of a tax audit that questioned the company's right to deduct input VAT when acting as intermediary in cross-border transactions. The SRS viewed the transactions as fictitious because the original seller (two unrelated Latvian companies) and the end buyer (a related Lithuanian company) had allegedly entered into a secret agreement. The SRS said the company was aware of that agreement and engaged in documenting the transactions as an intermediary to reduce the amount of value added tax (VAT) and corporate income tax (CIT) payable to the government.

The company was charged to additional VAT and CIT, plus interest on arrears and penalties. In this article we look at the substance of the case and analyse the Supreme Court's findings on arguments presented by the SRS and the administrative court.

## The substance of the case

In 2018 the SRS issued a decision to ACME Latvija SIA (the 'petitioner') on the results of a tax audit for the period from 1 February 2015 to 29 February 2016. In its decision, the SRS claimed the petitioner had wrongfully recorded input VAT on the purchase of mobile phones and tablets from Latvian companies Z-Elektro Baltic SIA and EK Tehnika SIA and wrongfully recovered that input VAT from the government after making a cross-border supply of goods to ACC Distribution UAB, a related Lithuanian company, and charging 0% VAT.

The petitioner disagreed with the SRS ruling and appealed to the administrative court, which agreed with the SRS findings based on the following facts:

- The petitioner was engaged in transactions to carry out formal activities (i.e. receive goods at his warehouse, enter consignment notes into a system used by the Lithuanian company, send goods and prepare documents) merely to create the impression of consecutive independent business transactions for malicious purposes. Therefore, even though the administrative court has not established that the petitioner knew or should have known about the secret agreement between the Latvian and Lithuanian companies, this has no decisive legal significance in this case.
- Contracts between the Latvian companies and the petitioner had been prepared formally and suggest the intention to justify fictitious transactions. The court said the contractual terms were incomprehensible because lots, prices and delivery dates were agreed by email, rather than being stipulated in the contracts.
- The sale of mobile phones and tablets is not the petitioner's usual business activity, meaning he has carried out some uncharacteristic transactions.

- The goods were not recorded in the petitioner's warehouse accounting program by being scanned.
- The court said the Lithuanian company would not be interested in buying goods through an intermediary in the normal course of business because the acquisition cost of such goods is higher and reduces the company's profit, which is not consistent with the goal of any commercial activity as generally understood.
- There is no clear reason for moving the goods from the Latvian companies to the petitioner's warehouse, with one of them paying for the transport to Lithuania.

Having assessed these facts, the administrative court confirmed that simulated transactions had been documented with the intention of wrongfully reducing the tax burden. The court found the transactions resulted in an understatement of output VAT payable to the government and in non-payment of CIT because prior-year losses were offset against the profit for 2015 (before the 2018 reform).

The petitioner appealed the administrative ruling to the Supreme Court, which examined the circumstances of the case and ruled as follows.

## The Supreme Court's findings

The Supreme Court examined the question of whether it has been correctly established that the petitioner was engaged in the disputed transactions as an unnecessary intermediary to formally prepare documents.

In hearing the dispute over an intermediary being involved in cross-border transactions, the Supreme Court offered several insights based on statute law and case law:

- Intermediation is a normal type of economic activity, so the petitioner's engagement in transactions as an intermediary does not necessarily mean that his transactions are fictitious, with no commercial substance, and that their sole purpose is tax fraud. However, this does not mean that an intermediary, just like any other company, is not supposed to have its goals and role in performing transactions. An intermediary cannot engage in transactions only formally, using its business details while in fact performing no activity.
- The Court of Justice of the European Union (CJEU) has recognised a taxable person's right to deduct input VAT regardless of the goal and result of his economic activity. It's likewise irrelevant whether the VAT due on previous supplies of goods has been paid to the government.
- According to the CJEU case law, taxpayers are free to choose any organisational structure and transactional procedures they see fit for their economic activity and for limiting their tax burden. However, a taxable person must be denied input VAT deduction if any fraudulent or malicious abuse of these rights is found on the basis of objective evidence.
- The Supreme Court agreed with the petitioner's argument that neither the SRS nor the administrative court had taken account of activities the petitioner carried out as an intermediary, including entering into agreements with suppliers on the range of goods and prices, receiving goods at the warehouse and organising transport to Lithuania. The Supreme Court therefore held that the administrative court had failed to assess all the evidence presented in the case, thus breaking the evidence assessment rules of the Administrative Procedure Act.
- The administrative finding that a company cannot be interested in engaging in a chain of consecutive transactions because this increases the overall cost, is invalid. The Supreme

Court confirmed the petitioner's argument that taxpayers are free to choose the most suitable organisational structure and transactional procedures that promote their economic activity and limit their tax burden.

- The administrative court has failed to consider the fact that where the existence of goods and their supplies is beyond doubt, the irrational nature of the chain of transactions from a business perspective or its insufficient justification per se cannot be treated as fraud. The Supreme Court said it was unclear why the administrative court had not discovered how the petitioner's actions in acquiring and supplying goods fail to justify his intermediary role.

Based on its assessment of the circumstances, the Supreme Court found that the administrative court had failed to duly assess all the evidence presented in the case for recognising the transactions as fictitious and establishing the petitioner's goal to abuse the tax system.

Accordingly, the administrative ruling was overturned and sent back to the court for a new hearing.

## Comment

Having examined the relevant law, the Supreme Court ruled in favour of the taxpayer and stated that intermediation per se is neither illegal nor unnecessary as long as the economic substance of transactions is justified and documented. This means that both the SRS and the administrative court are required to carefully assess all the transactions and evidence to determine whether any tax fraud has occurred.

The ruling makes it clear that every company is free to determine its own organisational structure and transactional procedures unless those are fraudulent. However, companies should be able to justify their organisational models and role in the chain of transactions, and all the transactions and movements of goods should be accurately recorded in their books. Regular accounting creates transparency and ensures evidence is available to the company's management and on tax audits.