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Court Rejects Limitation on Business Expense Deductions

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Court Rejects Limitation on Business Expense Deductions

A recent decision[1] by the Senate of Latvia's Supreme Court changed case law concerning the justification for limiting the business expenses that are eligible for a corporate income tax (CIT) deduction.

In the case at issue, the State Revenue Service (SRS) performed a VAT and CIT audit of a limited liability company (RDN) and held that the transactions recorded in the company's accounting books had not actually taken place, although RDN claimed increased business expenses and deducted a corresponding amount from its taxable income. The SRS therefore assessed additional VAT and CIT on the taxpayer.

RDN submitted an appeal to the regional court, asking it to overturn the assessment, but the court rejected the appeal. RDN then appealed the regional court's decision to the Supreme Court.

The Senate overturned the decision and sent the case back to the regional court for a new review, citing the following:

- the regional court had not correctly and completely evaluated the facts of the case to conclude that the applicant was not entitled to the deduction; and
- in determining whether the applicant was entitled to present the transactions as business expenses, the regional court had to verify whether the applicant knew (or should have known) that the transactions were fraudulent.

On the first point, the Senate's case law recognizes that within the meaning of article 10(1)(1) of the VAT law, in conjunction with article 1(9)(8), the deduction of a business expense can be claimed only if the taxpayer can produce an invoice for the relevant transaction. Therefore, it first must be determined whether the transaction was actually carried out from both an economic and a legal standpoint, and whether the invoice accurately reflects the transaction.

On the second point, the Senate, citing case law of the European Court of Justice, established that the SRS cannot deny a taxpayer the right to deduct a business expense from its taxable income on the ground that the issuer of the invoice or company's supplier performed illegal activities, unless there is objective evidence that the taxpayer knew, or should have known, that the issuer of the invoice or other supplier committed fraud.

The Senate had previously noted that information about the supplier is essential for determining whether the supply was made for an appropriate price and whether the taxpayer correctly calculated its CIT. If it is determined that the person identified in an invoice has not delivered the goods as represented, there is reason to assume that the transaction was not carried out and that any costs incurred are not related to the taxpayer's business activity, according to the Senate.

The same documents (bills confirming the transaction) are taken into account in calculating CIT and VAT, both of which are subject to articles 2 and 7(1) of the Law On Accounting concerning, respectively, authentic information disclosure in accounting and the requirement that entries in the accounting records match the source documents.

The Senate held that the approach advocated by ECJ case law should be used to ascertain business expenses that should be included in calculating CIT. If the tax authorities and regional court have reason to doubt whether the transaction was carried out with the counterparty indicated, it must be determined whether the taxpayer itself was involved in tax fraud.

In making that determination, the Senate departed from its previous case law, under which any reason to doubt the legitimacy of a transaction was sufficient justification to exclude it when determining deductible business expenses. ◆

[1]Case SKA-21/2013 of June 12, 2013.

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