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Tax alert

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Legal acts

On the 25th of May the Administrative Law Chamber of the Supreme Court settled a tax dispute, on whether the income tax exemption applies when the heir sold the real estate which had been returned to his father in the course of ownership reform; and if yes, then on which grounds.

Circumstances

According to the content of the tax dispute, the Tax and Customs Board did not agree with the seller, who was an heir to ½ legal share of real estate in Pärnu County and who applied income tax exemption on the sale of the property. It is important to note that the property consisted of two cadastral units, on one of them at the time of the sale were buildings needing repair, which were not registered in the Register of buildings, including dwelling, barn, shed, etc.

The appellant argued that according to Income Tax Act (ITA) § 15 (4) 5) tax exemption was applied to the cadastral unit without buildings and according to ITA § 15 (5) 2) income tax exemption was applied to the cadastral unit with the buildings (incl. dwelling).

According to ITA § 15 (4) 5) the income from the transfer of the property returned in the course of ownership reform is tax exempt and according to ITA § 15 (5) 2) the gains from the sale of that property is tax exempt, when an essential part of the property is a dwelling and the immovable has been transferred to the taxpayer's ownership through restitution of unlawfully expropriated property.

The opinion of the Supreme Court

The Supreme Court resolved the question, whether it is possible to apply the tax exemption to two cadastral units separately (as the appellant did). The court ruled that ITA § 15 (5) 2) provides tax exemption to the full amount of gains from the sale of the immovable property. Therefore, when selling an immovable property with a dwelling it is not possible to use the income tax exemption differently on two cadastral units. Supreme Court also noted that from the point of view of taxation, it did not have any meaning that the dwelling needed repair.

Is the Tax and Customs Boards interpretation for ITA § 15 (4) 5) too narrow?

The Supreme Court found that because the essential part of the sold immovable was the dwelling (among other things), then the basis for the tax exemption was ITA § 15 (5) 2) (specific provision) and not (4) 5) (general provision).

By explaining the difference in these provisions the Supreme Court noted (paragraph 13 of the decision), that in relation to ITA § 15 (4) 5) the exemption applies to the immovable property (land) on which there could be also other buildings that are essential parts of the property other than dwelling.

It can be concluded that the current understanding and interpretation of the Tax and Customs Board, that ITA § 15 (4) 5) can only be applied to a land without buildings, is too narrow. It is also worth noting that the administrative court regarded the treatment unequal in situation where according to ITA § 15 (4) 5), the successor on whose land there is a growing forest would be entitled to income tax exemption and the successor on whose land there are buildings would be not. Therefore, the correct interpretation of this provision is that the exemption covers, in addition to land, all of the essential parts of the immovable, in particular the buildings, regardless of whether the buildings and land were returned at the same time or separately.

Is the tax exemption provided in the ITA § 15 (5) 2) transferable to the heir?

Supreme Court concluded, that because the transfer of immovable was not carried out by the bequeather (or acquired

by the successor), but the owner was replaced, the succession of a property returned in the course of ownership reform does not exclude the application of the income tax exemption provided for in ITA § 15 (5) 2).

To the question whether the income tax exemption in the provision was an inseparable right of the bequeather, the Supreme Court replied negatively. To justify it, the Supreme Court argued that the succession did not change the way the inherited property was acquired, which was the main condition in the provision, and the inherited property was still immovable transferred through restitution of unlawfully expropriated property.

In addition, the Supreme Court explained the difference between provisions of ITA § 15 (5) 1) and 2). Clause 1 provides that the income tax exemption can be used if the taxpayer used the sold dwelling as his place of residence. This is a condition that no other person can fulfill and that cannot be transferred to the heir- this means that the heir could use this provision for income tax exemption only if they have used the dwelling as a place of residence, otherwise it would be subject for taxation.

Therefore, in this situation, according to ITA § 15 (5) 2) the successor was entitled to use the tax exemption instead of the bequeather and can receive tax refund.

The Tax and Customs Board has partially changed their interpretation as a result of the decision

The new interpretation of the Tax and Customs Board shows that the interpretations for ITA § 15 (5) clauses 5)[1] and 3)[2] are still partially negative, justifying it by referring to the judgement of the Tallinn Circuit Court of January 2015 in the matter No 3-14-50711. According to Tax and Customs Board, it is important to distinguish on which basis the heir received the inherited property, either in the course of ownership return or through privatisation with the right of pre-emption and depending on this the heir can either apply the tax exemption or not.

[1] 5) a structure or apartment as a movable has been transferred to the taxpayer's ownership through restitution of unlawfully expropriated property or through privatisation with the right of pre-emption.

[2] 3) an essential part of the immovable or the object of apartment ownership or a right of superficies is a dwelling and such dwelling and the land adjacent thereto has been transferred to the taxpayer's ownership through privatisation with the right of pre-emption and the size of the registered immovable property does not exceed 2 hectares.