

# Repaying mortgage on inherited real estate means investing in functionally similar property 2/2/22



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On 8 October 2021 the Supreme Court announced a ruling on case SKA-301/2021 regarding expenses a person incurs in repaying a mortgage on an inherited real estate (RE), which may be treated as an investment in a functionally similar RE.

Basically the Supreme Court examined whether a tax deduction may be claimed on the sale of a person's sole RE under section 9(1)(34.2) of the [Personal Income Tax \(PIT\) Act](#), which exempts income arising on the sale of a taxpayer's sole RE entered on the land register if that income is reinvested in a functionally similar RE either before or within 12 months after the sale.

In analysing the treatment of a functionally similar RE, the Supreme Court finds that the PIT Act fails to specify any manner of acquiring RE and so there are no grounds for excluding from this treatment any cases where RE is acquired by exchange, gift or inheritance, but not purchase.

## Background

An individual inherited a one-fourth notional share of a house (a cadastral value of EUR 8,121). A couple of months later the person sold another apartment he had owned for ten years (his sole RE before receiving the inheritance) for EUR 56,000, without filing a capital gains return on the income. Some of the money (EUR 32,038.58) was used to repay the loan on the inherited portion of the house.

A dispute arose between the person and the State Revenue Service (SRS) over claiming an exemption available under the PIT Act on an investment in a functionally similar RE and over the proper way of charging PIT. The SRS required the person to pay PIT on the proceeds from the RE sale after reducing the taxable amount by one-fourth of the cadastral value of the inherited house, as well as expenses associated with the inheritance case.

The Regional Administrative Court heard the case and reduced the person's taxable income. As well as the items mentioned by the SRS, the acquisition cost and the total amount invested were deducted from the income.

## The Supreme Court's findings and ruling

The Supreme Court overturned the regional court's finding that under [section 9\(1\)\(34.2\) of the PIT Act](#), the RE value (cadastral value) appearing on the inheritance certificate may be treated as an investment in a functionally similar RE. Inheritance is a method of acquiring property for no consideration, so the person has not incurred any expenses to be actually assessed (other than those associated with the inheritance case) and the cadastral value of the inherited RE cannot be treated as an investment.

The Supreme Court also found that this case is not a typical one, yet acquiring RE through inheritance is

not excluded from the scope of this clause. Accordingly, instead of the purchase price, some other expenses that allow the person to use the RE for its purpose may be treated as an investment. Repaying a mortgage is considered a substantial precondition for him to use the part of the house as his future place of living, so repaying the loan is treated as investing in a functionally similar RE. This is consistent with the case-law finding that the lawmaker intended to exempt individuals from PIT where a person sells his sole RE and this action has no characteristics of a speculative transaction.

The Supreme Court found that [section 9\(1\)\(34.2\) of the PIT Act](#) fails to specify a legal manner in which the person has to acquire a functionally similar RE. If the other RE has been acquired as a result of any legal relationship other than a purchase, then expenses allowing the person to use the RE for its purpose, not the purchase price, may be treated as an investment.

Thus, if the person uses the funds obtained as a result of selling one RE to repay the mortgage on the inherited RE, and this action is considered a substantial precondition for him to use the inherited RE as his future place of living, then the money spent to repay the mortgage may be treated as an investment in a functionally similar RE, which allows a PIT deduction.

## The takeaway

The court assessed whether the funds obtained from selling the apartment and applied for repayment of the loan are considered an investment in a functionally similar RE and whether this is a basis for claiming a PIT deduction. There is no dispute that PIT is due on the part of the RE sale proceeds that is not invested in a functionally similar RE. According to the Supreme Court's ruling, when the person files a capital gains return and reports the income arising on the RE sale, the following deductions should be made from the taxable base for PIT purposes:

- The acquisition cost
- The total amount invested
- Expenses associated with the inheritance case
- Expenses incurred in repaying the mortgage on the inherited RE (an investment in a functionally similar RE)

If taxpayers use the Supreme Court's findings in practice, then we will see an increase in the number of cases requiring the SRS to assess the substance of investment – expenditure – in order to correctly apply the scope and relief of the PIT Act. Yet the taxpayer must be able to prove that repaying the liability is consistent with the purpose of using the RE from another legal relationship in a functionally similar way to the RE sold.