You sell property, cancel transaction, and still pay capital gains tax? 2/20/23

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This statement does not seem to make sense and is contrary to what the law says about capital gains tax being payable only on income that results from a disposal of real estate (RE). However, a certain taxpayer had to fight in court for his right to be exempt from a tax liability on an RE disposal.

The circumstances of the case and the position of the State Revenue Service (SRS)

In this case the claimant had acquired RE under a gift agreement. In 2014 she gifted it to her son. In early 2015 the son entered his legal title to the RE on the land register, but a few months later the mother and son cancelled the transaction by entering into a cancellation agreement. In summer 2015 the claimant's title was entered on the land register again. In 2016 a land unit was separated from the RE and the newly formed property was sold. In 2017 the claimant sold the remaining part of the RE.

The SRS found the claimant had not paid personal income tax (PIT) on income resulting from the RE disposal. The SRS ignored the fact that the claimant had held the RE since 2001, and claimed she acquired it in 2015 under the cancellation agreement. Because the disputed property was sold in 2017, the condition in section 9(1)(33) of the PIT Act for exempting PIT is not met, i.e. the claimant had not held the RE for more than 60 months.

Court hearings and rescue found in the Supreme Court

Amazingly, the court initially upheld the SRS's position, believing the claimant had acquired the RE under the cancellation agreement. The court found that since the claimant's son had already entered his title on the land register, the cancellation agreement created a new title. Accordingly, the SRS was right to believe the claimant had held the RE for less than 60 months, so capital gains tax was due. The only thing the court disagreed with was the principle used for determining the tax base. Specifically, the SRS had determined the RE acquisition cost according to the original property acquisition document, i.e. the gift agreement of 2001 stating the value of the disputed property. Yet the court found the acquisition cost should be determined according to the cadastral value in 2015 and calculated in proportion to the area of the separated property.

It is noteworthy that the taxpayer had in fact resigned to her fate and did not appeal the court ruling. But the SRS was not willing to give an inch and filed a cassation appeal to the Supreme Court, objecting to the acquisition cost being determined differently from the SRS's decision.

After hearing the appeal, the Supreme Court overturned the regional court's ruling and referred the case for a new hearing.

Firstly, the Supreme Court pointed out the essence of capital gains tax and conditions for charging it. Based on its own case law, the Supreme Court stated that capital gains tax is payable on income gained,

so the hallmark of this taxable item is the gaining of income. To calculate the tax due, we should first determine a capital gain by deducting the acquisition cost and the value of investment made in the capital asset during the holding period from its selling price.

Secondly, the Supreme Court found that if the cancellation agreement has cancelled the transaction through which income was gained, and there is no particular income and there can no longer be any, then imposing an obligation to pay tax on such non-existent income would be contrary to the meaning of the income tax item and the lawmaker's intention. So, if the disposal is cancelled, then income on the disposal, which has not been and will not be received, cannot be treated as income from capital.

Thirdly, in assessing the claimant's individual situation, the Supreme Court found she had gained income by selling separately each of the parts of the RE, which had been recovered and later divided, rather than from the transaction that was cancelled by the cancellation agreement. There is no doubt the claimant gained income under these disposal agreements. Yet the legal consequences of the parties entering into the cancellation agreement are significant also in determining whether this income is taxable. Specifically, while the disposal agreement and the cancellation agreement may formally be treated as two distinct transactions, a "new claim" within the meaning of the Civil Code's section 1865 exists so the parties could mutually settle their obligations arising from the cancellation of their previous obligations. The cancellation of their previous obligations is understood to create new, opposite obligations – each party has to return what he received earlier. Yet in the context of tax payment we need to consider the essence of these obligations, i.e. the earlier disposal agreement is cancelled and the previous situation restored. This means the claimant recovers her pre-existing title to the RE, rather than acquiring title anew. This is relevant to applying the PIT Act's section 9(1)(33). This clause exempts income arising on the sale of RE the taxpayer has held for more than 60 months (from the date it was entered on the land register) and which has been the person's declared residence for at least 12 consecutive months (in that 60-month period) until the disposal agreement was concluded.

In view of this, the Supreme Court did not find any legal reason for why the period between the claimant's first acquisition of title in 2001 and the gift she made to her son in 2014 should be ignored in determining her holding period. It is important that through the cancellation of the gift agreement the claimant recovered the same RE she had held for a long time before. An unsuccessful (cancelled) disposal per se does not lend a business nature to the dealing with the property, nor does it make non-existent the period during which the claimant held the asset. At the same time, the PIT Act's section 9(1)(33) requires a finding of title entered on the land register, so the period during which the claimant's title was not entered on the land register after the gift agreement had been made should be ignored in measuring her holding period.