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Supreme Court's ruling on income from property contribution upholds tax authority's approach to applying Personal Income Tax Act 3/16/21

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On 4 September 2020 the Administrative Division of the Supreme Court ruled on case No. A420190717 SKA-383/2020 concerned with the personal income tax ("PIT") treatment of a property contribution. The ruling reinforces the understanding of how PIT is deferred for an individual that has contributed capital assets (e.g. real estate or trademarks) to a company's share capital in exchange for shares.

Background

The Supreme Court finds that income from contributing capital assets to a company's share capital is subject to PIT but this liability is deferred until the person disposes of shares received in exchange under sections 11.9(7.4) and 16.1(4.1) of the PIT Act. The tax base is the nominal value of the shares and the person's acquisition cost of the capital assets.

The dispute between the State Revenue Service ("SRS") and the person was not over the obligation to pay PIT on the income from the property contribution but rather over a different approach to interpreting tax rules. The SRS does not believe the law should be interpreted in a way that accepts a tax-deductible loss arising on the person's subsequent gift of shares. However, the person believes that the property contribution and the gift of shares received in exchange are two consecutive transactions and their PIT treatment should be evaluated separately. So the person believes that the loss arising on the gift of other capital assets (shares) should be deducted from the profit arising on the contribution of capital assets (real estate) in the same tax period.

Since 2010 the person had owned several properties acquired for a total of EUR 93,256.68 (including stamp duties). In January 2015 the person contributed the property to the share capital of a public limited company in exchange for 405,000 shares totalling EUR 405,000. The person later gave all the 440,000 shares, 35,000 of which had been acquired earlier, away to a certain foundation.

The litigation

In 2016 the SRS performed a partial PIT audit of the person's income from capital gains arising on the property disposal in 2015 and issued their original decision assessing additional PIT as well as charging a penalty and interest. The SRS decision was based on the obligation to pay PIT on the property contribution to share capital, on the grounds that the contribution generated a capital gain which materialised on the day of the share gift.

The person challenged the original decision to the SRS Director General, who upheld its findings and reiterated that the property contribution gave the person income attracting a 15% PIT.

The person challenged the Director General's decision to the district administrative court. The person stated that the gift of shares to the foundation is a disposal within the meaning of the Civil Code which should be considered separately, and in January 2015 the person made both a profit on the property contribution and a loss of EUR 440,000 corresponding to the value of shares at the time of the gift. There is no capital gain because the person has disposed of two capital assets. Adding up the profit and loss on the two transactions has a negative outcome, so there is no tax base.

However, the SRS stuck to the arguments set out in their original decision, claiming that it is impossible to distinguish two disposals. The SRS said an annotation to the PIT Act implies that a property exchange for shares results in the person earning income that materialises on their disposal.

Having assessed all the circumstances and explanations offered, the district administrative court dismissed the person's application because the SRS decision is lawful and reasonable.

The person appealed to the regional administrative court, who found that the person made two disposals. This ruling is based on the finding that the lawmaker never intended to disregard the gift as a type of capital asset disposal or to ignore it in computing the PIT base. Accordingly, the provision for adding up positive and negative gains on capital assets has been adopted along with amendments to the PIT Act which recognise gifts as taxable income (with the exception of persons related by marriage or consanguinity up to the third degree).

The regional court states that under such conditions it has no grounds for creating new case law by imposing any unfavourable restrictions, so the person's application was granted by recognising that the lower court had misinterpreted the rules.

However, the SRS appealed to the Supreme Court. Having evaluated the circumstances and the interpretation of law, the Supreme Court invoked two case law rulings that can be applied to other cases and disputes over PIT being charged on income arising on a property contribution to a company's share capital.

The finding

The Supreme Court did not evaluate whether the loss claimed by the person on the share gift could be offset against capital gains arising on the property contribution. The Supreme Court found that under the PIT Act the person earns income from the property disposal if he contributes it to a company's share capital in exchange for shares worth more than the acquisition cost of the property. Yet the person is not treated as having received income until the shares are disposed of.

The Supreme Court also recognised that the disposal by sale or otherwise of shares acquired in exchange for the property contribution cannot be viewed as a separate transaction. The share disposal is a tool that helps the person allocate income from the property contribution for taxation.

So the Supreme Court has returned the case for a repeated hearing.

Our opinion

Many countries have adopted rules allowing a person to avoid having to pay tax immediately on dealings in capital assets if they are exchanged. The principle being applied in such cases provides for the possibility of deferring the tax liability on the exchange of capital assets because no money is received and the person would have to pay PIT out of some other funds that are not directly linked to the transaction. Indeed, deferring the PIT liability until the share disposal is closely linked to income from the transaction being received in cash, which then becomes available for paying PIT.

The PIT Act defines no other case of capital assets being exchanged without realising any cash income, such as contributing those shares. By analogy such an exchange of capital assets could take place endlessly, deferring the tax liability again and again. In practice, however, the SRS has stated that this rule applies only to a one-off contribution and any subsequent share dealing triggers the deferred tax liability. Also, the SRS could by analogy state that the gift, inheritance or transfer of shares in any other way is considered a disposal that triggers the obligation to pay the deferred tax. This case shows that the SRS uses this analogy in practice.

In view of this, the regional court will have to assess whether a transaction without a consideration and receipt of money is considered one that triggers the deferred tax liability or whether the liability passes along with the shares to their new owner and remains deferred in the future.