

OVERVIEW OF THE LEGAL SITUATION IN A COMMERCIAL PROPERTY WHEN ACQUIRING AN APARTMENT LOCATED IN A SHORT-TERM ACCOMMODATION BUILDING

1. GENERAL

1.1. Natural and legal persons

When purchasing an apartment (Apartment) on Esplanaadi 10 (Building), it is worth noting the following. The building will be rebuilt and divided into apartments. Each apartment is entered in the land register as an independent property unit. This means that each apartment can be bought, sold or rented separately, and a mortgage can be set on it that would, for example, guarantee the obligations arising from the loan agreement.

The Apartment is acquired in a situation where the purpose of land use at Esplanaadi 10 is 100% commercial land, and the main purpose of use of the building is “Other short-term accommodation” (Register of buildings, code 12129).

The developer will rebuild the Building and ensure its compliance with the requirements for accommodation business. The future owner of an Apartment can use it as a temporary or permanent residence at their discretion.

Due to the purpose of use of the Building there are some tax and legal issues related to the acquisition and use of Apartments, and we would like to explain the most important ones to you.

1.2. Purpose of use of the Apartment

It is expected that the purpose of use, and the use permit of the Building will be indicated as “building for other short-term accommodation, including guest apartments.” According to the Tourism Act, a guest apartment is an accommodation unit with the purpose of use as providing accommodation services or renting out the apartment as a whole (short-term rent). If you want to use the Apartment as your own permanent home and register it in the population register as your permanent residence, you must submit a residence notice, similarly to any residential apartment. It is important to bear in mind that the registration of the Apartment as a permanent residence may lead to complications while deducting the VAT paid on the acquisition of the Apartment, as this indicates that the purpose of use of the Apartment is a dwelling, not an accommodation.

1.3. Differences between short-term accommodation and a regular apartment

Natural persons are allowed to deduct the interest paid on a loan, taken for the purchase of an Apartment, from their declared and taxed income, provided that the Apartment has been used during the taxation year as a dwelling only. If the Apartment has been rented out during a taxation year, then the deduction of loan interest from taxable income is not allowed for the period of the rental agreement. This means that natural persons, if they have rented an

Apartment out during the year, when submitting an income tax return must deduct the amount of loan interest paid during the rental period, from the loan interest paid for the whole year.

Self-employed persons (FIE) can declare the interest paid on a loan taken for the purchase of an Apartment as a business expense, provided that the rental of the Apartment is a business income of a self-employed person, or the acquisition of the Apartment is directly related to generating business income.

2. VARIOUS TAX ISSUES

As the acquisition of property is a tax area rich in nuance, and different transactions can be made with one property over the years, the taxation of services provided with the same immovable asset may also change, depending on the changes in the use of the immovable. In the following, we try to provide more information about the conditions of taxation, using examples of different transactions.

2.1. What should be borne in mind in relation to VAT, when purchasing a guest apartment?

Example 1. A private limited company (OÜ) acquires an Apartment with the aim of renting it out as a guest apartment. Legal entities that acquire an Apartment for the purpose of short-term lease (renting for less than three months, hereinafter **accommodation service**) have the right to claim back VAT on the purchase price. Such intention or business plan can be proven with existing advertising/announcements, a cost-profit forecast, thought-out details of service, contract terms referring to the accommodation service, etc. If a private limited company acquires an Apartment for the purpose of long-term lease, VAT cannot be reclaimed from the acquisition price, as the income from the long-term rental (more than three months) is tax-free turnover. In justified cases, the tax authorities have accepted a VAT refund in some situations where the accommodation service was provided for a period longer than three months. In such case, the terms of the contract, the business plan, and the communication addressed to the persons living in the Apartment must clearly confirm that, despite the longer period, it is still an accommodation service and not the rental of a dwelling.

Example 2. A private limited company acquires the Apartment and Toomas, a member of the Management Board, will use it as a dwelling for his own use. Legal entities that acquire an Apartment for the personal free use of a shareholder, member of the management board or employee, cannot apply for a VAT refund from the acquisition price. If a private limited company rents out an Apartment, for example, for three days a year, VAT can be reclaimed on the purchase price in proportion to the extent of those three days. Also, if a member of the Management Board uses the Apartment as his/her own dwelling, a special preferential tax (income tax at the rate of 20/80 + social tax of 33%) must be paid on the market price of the rental. Payment of the special preferential tax does not apply if a partner, member of the management board or employee of a legal person uses the Apartment for personal purposes on the basis of a rental agreement for a rental fee corresponding to the market price.

Example 3. Toomas buys an Apartment and uses it for personal purposes, i.e. lives there all year round. Natural persons, who are not involved in business and have not registered themselves as a taxable person and acquire an Apartment for personal use, cannot claim a VAT refund. Also, natural persons who are not registered as taxable persons, cannot reclaim VAT on the purchase price of an Apartment if they purchase it with the purpose to rent it out.

2.2. Is the income from the rental service of a guest apartment taxable or a tax-free turnover?

Example 4. A private limited company has acquired an Apartment according to Example 1 and will rent it out as a guest apartment. The accommodation service is subject to a VAT rate of 9%. If the Apartment is let out for long-term rent (more than three months), it is generally a tax-free turnover. However, a transaction of renting an apartment as a business premises may be voluntarily taxed at a VAT rate of 20%, informing the tax authorities in advance. The tax authorities can be notified by submitting a free-form application through the e-service of the Tax and Customs Board maasikas.emta.ee. or by sending an e-mail to emta@emta.ee. The rental of an apartment as a dwelling cannot be voluntarily taxed with VAT.

Example 5. Toomas uses the Apartment for a while as his own living space, but after some time he feels the need for more spacious home. So, Toomas decides to rent out this Apartment. In the case of a short-term rental (provision of accommodation service) or a long-term rental (longer than three months) natural persons, who are not involved in business and have not registered themselves as a taxable person, cannot claim a VAT refund on apartment rental transactions. In addition, natural persons undertake to pay income tax on the rental income from the Apartment they own, declaring the rental income in their annual income tax return.

2.3. Do natural persons have to pay income tax, when selling a guest apartment?

Estonian legislation clearly distinguishes the concepts of dwelling and commercial space. A dwelling is a living space or apartment, that can be used for permanent residence, a commercial space is a space used for economic or professional activities. The Apartment covered in this overview is a guest apartment, i.e. an accommodation unit, which is rented out in full, so the Apartment has a business purpose and therefore, as a rule, in the case of natural persons, the apartment is not subject to an income tax exemption. However, there may be exceptions in situations where business premises are actually used as a place of residence and, in such case, evidence of that is required.

Example 6. Toomas has acquired an Apartment and used it as his residence for more than two years. In practice, the right for tax exemption is determined on the basis of the actual use of the premises. The Supreme Court has stated that, in distinguishing living and business premises, it is not only the purpose of the building (residential or non-residential) indicated in the detailed plan, and the building or use permit that are taken into account, but also the intention and actual possibility to use the premises for one purpose or another. Thus, the norms of building law do not prohibit the use of a residential building or an apartment located within for temporary residence. The apartment in the residential building can also be used, for example, for the provision of accommodation services, i.e. in business activities. Unlike a regular apartment, which is intended for residential use, the guest apartment has a commercial purpose of use. If the taxpayer used the guest apartment as his own place of residence until the transfer of property, and this is proven, it may be justified, in exceptional cases, to apply a tax exemption to the sales of such an apartment as well. The tax exemption is valid for one sales transaction in two years.

Example 7. Toomas has bought an Apartment and rented it out, earning rental income on it, now he has decided to sell the Apartment at a profit. If Toomas has not used the Apartment as his actual residence, and decides to sell it at a profit, Toomas must pay an income tax of 20% on the profit.

2.4. Is the VAT reclaimed from the purchase price subject to set-off, when selling a guest apartment?

Example 8. The private limited company has acquired the Apartment as described in Example 1 and reclaimed VAT on the purchase price. Five years later, Toomas, a member of the Management Board, decides to sell the Apartment. If VAT is deducted as input VAT, when buying an apartment and VAT is added to the sales price when selling, then no offsetting will take place. If VAT has been deducted as input VAT upon acquisition of the Apartment and the Apartment is transferred in ten years without VAT, the VAT deducted upon acquisition of the Apartment is subject to adjustment (in this example proportionally 50% of the sales price's VAT).

However, the above-mentioned details are not unambiguously applicable to different transactions, as in the case of each transaction all the circumstances of the transaction and different nuances must be taken into account, including the parties of the transaction.

The preparation of this overview shall not be considered as the provision of legal services to third parties.

In compiling the memo, the information known at the time of compiling has been taken into account. It is therefore necessary to assess all relevant information in every particular case and bear in mind that the legal framework may have changed.

A tax advisor or, if necessary, a tax inspector can share more detailed information and help clarify each particular transaction.

With respect,

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