Chancellor’s Year in Review 2022/2023

Money

Dealing with crises requires money, which is never unlimited. There are always questions about the expediency and conditions for distribution of support and implementation of aid measures. More important financial choices must be made by the Riigikogu, and the comprehensibility and transparency of the state budget is becoming increasingly important.

During the reporting year, the issues of tax and banking services and measures to combat money laundering, as well as the issues of payment of support intended to mitigate the effects of the crisis, came to the attention of the Chancellor.

Clarity of the state budget

Under § 115 of the Constitution, making important budgetary decisions is the task of the Riigikogu (“the budget of all state revenue and expenditure”). In a situation where the state’s expenditure exceeds revenue and the budget is therefore in deficit, the work of the Riigikogu is complicated. This means that the Riigikogu will have to make increasing efforts to find a suitable balance point for the majority of society in deciding on cutting expenses and tax increases planned to cover borrowing and the deficit.

The structure of the state budget should be such that the Riigikogu can decide, to the extent necessary and relevant for it, on the reasonableness and expediency of using state funds. Therefore, the state budget must be understandable, or otherwise the Riigikogu will be unable to perform the task assigned to it by the Constitution.

When planning the budget, decision-makers still focus only on the economic substance of the expenses that they understand, i.e. on activities. Activity-based budgeting involves a lot of additional work, the results of which are not used or are only little used. The benchmarks used to assess programme objectives set out in the explanatory memorandum to the state budget are often vague and give the impression that the state is engaged in substitute activities. If understanding the cost figures given under the objectives is impossible and if understanding requires unnecessary additional work, serious consideration should be given

to whether it is reasonable to continue with activity-based budgeting at all.

The Chancellor drew attention to problems related to the budget in the letter "The right to decide on the budget", sent to the Riigikogu committees, in a presentation prepared for the Riigikogu Finance Committee, as well as in a letter sent to the Ministry of Finance about the intention to prepare the State Budget Act. The Chancellor recommended that the Minister of Finance might also consider amending the State Budget Act so that budgetary decisions concerning constitutional institutions would be made by the Riigikogu in the future and the government would have the role of submitting their opinion, if necessary.

Availability of basic payment services

The Chancellor has been approached by both businesses and individuals who are concerned about having their bank account closed without having been given any substantive reasons for doing so. As a rule, other banks then also refuse to open an account for the person, and as a result, managing their everyday affairs becomes almost impossible.

The Chancellor explained in a letter to the Estonian Banking Association that currently two related problems are being reviewed by the Chancellor. The first concerns the obligation of banks to provide reasoning if a bank decides to refuse to open an account or to close it. The second issue concerns everyone's right (§ 14 Constitution) of access to basic payment services that are essential for day-to-day living.

In conclusion, the Chancellor noted that, in order to ensure better legal protection, banks will have to provide substantive reasoning as to why they have decided to terminate a payment services contract. The Supreme Court also recently explained that a bank may extraordinarily cancel a client's basic payment service contract only for a good reason.

Closing a bank account also restricts access to vital services. Among other things, it may prove impossible to pay for utilities, childcare and other services, as the Chancellor explained by referring to her earlier opinions. This, in turn, means that the constitutional right of access to the court, free self-realization, family law, freedom of enterprise and the fundamental right to property are restricted (§§ 15, 19, 27, 31, 32 Constitution).

Banks also take care of combating money laundering and terrorist financing as an important national objective. At the same time, people need a bank account to cope on a daily basis, regardless of how their activities are legally evaluated. Depriving a person of all access to all

basic payment services can lead to social and economic exclusion.

The solution may be to provide a so-called social bank account. When using this account, the volume and purpose of transactions can be limited by law. Where necessary, a suspect's transactions can also be effectively checked. However, when people suspected of money laundering or terrorist financing are directed to settle through front persons or in cash, this works directly against national objectives.

If, during court proceedings, a company is deprived of the right to use an account, the resulting restriction on fundamental rights may not be as intense as if a natural person loses their account. Securing a court claim can reduce the intensity of the restriction.

Compatibility with the Constitution of anti-money laundering measures and justification of measures in explanatory memorandums

The Chancellor has been asked to check whether measures and restrictions established in § 20 of the Money Laundering and Terrorist Financing Prevention Act (MLTFPA) comply with the Constitution. Dissatisfaction was caused by the requirement that a person must also prove to a notary the origin of the money in their bank account, although the bank has already checked this beforehand.

If, in a real estate transaction, both the bank and the notary ask the buyer to prove the origin of their assets, this may limit the buyer's ability to freely dispose of their assets and, moreover, a person must repeatedly disclose information about themselves. Thus, applying a due diligence measure may restrict the right to property (§ 32 Constitution), freedom to conduct a business (§ 31), the right to informational self-determination (§ 26) and free self-realization (§ 19).

Nevertheless, the Chancellor found no conflict with the Constitution. Banks and notaries are obliged entities that need to apply due diligence measures to prevent money laundering and terrorist financing. This obligation is imposed on notaries by §§ 19 and 20 of the MLTFPA. Notaries can cooperate with other obliged entities while applying due diligence measures (§§ 16 and 24 MLTFPA), but this is not an obligation. It is the responsibility of the obligedentity itself, in this case the notary, to ensure compliance with the due diligencerequirements. This is necessary to ensure compliance with anti-money launderingrequirements. No obliged entity is required to assume that due diligence measures havebeen applied sufficiently effectively for a particular transaction.

The Chancellor also analysed the constitutionality of § 44 of the MLTFPA. This provision stipulates that an obliged entity may transfer the client's assets only to those accounts that meet the conditions set out in the MLTFPA. Transferring the client's assets, for example, to accounts located in payment institutions and electronic money institutions regulated by the Payment Institutions and E-Money Institutions Act is not allowed.

A restriction on the transfer of assets restricts a person's right to freely use and dispose of their property (§ 32 Constitution). If limiting the transfer of assets serves and helps to achieve a constitutional purpose, there is no reason to conclude that the requirement is unconstitutional.

The Chancellor reached the opinion that – taking into account the explanations in the national risk assessment, international studies, as well as by the Financial Supervision Authority and the Financial Intelligence Unit – there is currently no basis to assert that the restrictions on transfer of assets laid down by § 44 of the MLTFPA would be unconstitutional when assessed in the abstract. These restrictions prevent assets from being transferred to an environment where there is a higher risk of money laundering and terrorist financing and where less effective due diligence measures are generally applied to prevent this.

The Chancellor also pointed out that, when imposing measures restricting the right to property, restrictions should be clearly justified, and this should also be done in the explanatory memorandum to the provision imposing the restriction. In doing so, reference should be made to relevant risk assessments and studies. The explanatory memorandum helps both market participants and the general public to understand the need forrestrictions. This, in turn, helps to understand the importance of preventing moneylaundering and terrorist financing.

Taxes

Tax-free income for children

Questions arose in connection with the distribution of tax-free income for children. The Chancellor was contacted by a parent raising three children: two of them from an earlier and the third from a later cohabitation. When it was found that both parents had declared tax-free income for the first two children, the Tax and Customs Board adjusted the income tax return of one of the parents so that the tax-free income for the children was applied to the taxation of that parent's income only for the months in which the parent had received child allowance for those children. The Tax and Customs Board also reduced the tax-free income provided for the third child, although the child allowance for that child had been received by the petitioner throughout the taxation period.

The Tax and Customs Board explained to the Chancellor that the petitioner was still entitled to the additional tax-free income for the third child for the entire taxation period and stated that the Board had re-adjusted the income tax return of the petitioner. As a result, the parent finally received an additional income tax refund.

Although the specific concern was essentially resolved, the Tax and Customs Board erred against the requirements of the law because the tax authorities are not allowed to amend income tax returns of persons without making a decision. The Board may amend the declaration only with the consent of the person who submitted it. If there is no consent, the Board must issue a decision to adjust the tax records and file a claim for refund. This must be the case even if the parents have not reached an agreement between themselves on the distribution of the tax incentive.

From a decision, i.e. an administrative act, a person can find out under what circumstances

the tax authorities applied the law in a specific way. The tax authorities must give reasons for their decision, refer to the rules of the relevant legal act, and provide a description and explanation of the facts. The decision must also make it clear how and for how long a person can challenge the act.

The Chancellor recommended that the Tax and Customs Board should comply with the law and draw up an administrative act before amending the data submitted in people's tax returns. The Board agreed with the Chancellor's recommendation.

Taxation of pensions

The Chancellor received repeated complaints about the taxation of pensions. Some people consider taxation of an already scarce pension to be fundamentally wrong, considering that a pension is a reward earned for long-term work that should not be taxed by the state. Others were dissatisfied with the fact that a pension received from a foreign country affects the amount of tax-free income, while others complained about taxing the income of working pensioners.

An old-age pension received from a foreign country is not taxed in Estonia, but receiving this pension may still have reduced the amount of tax-free income in 2022. As a result, a situation may have arisen that if a person received a pension from a foreign country, they had to pay more income tax on their Estonian pension.

The Chancellor found that whether and to what extent a pension should be taxed depends on political choices. No reason exists to assert unconstitutionality of the rules on tax-free income, according to which income from abroad is also taken into account when calculating the tax deduction.

With regard to the income tax liability of a working pensioner, the Chancellor noted that tax-related choices are essentially political choices made by the Riigikogu elected by the people. The Riigikogu must find a fair balance in the distribution of the tax burden in society. Whether and from what threshold the income of a working pensioner can be taxed is indeed a question of such a balance.

The Riigikogu changed the taxation of income of old-age pensioners. From 1 January 2023, a separate tax-free income (instead of graduated tax-free income) will be applied to the taxation of income of people in retirement age. Also, in the future, income earned in a foreign country will not affect the taxation of income received from Estonia by people in retirement

age.

The Chancellor was also asked to assess whether it is constitutional that the tax incentive for old-age pensioners is not granted to all pensioners but only to people in retirement age. Although the law gives a person the opportunity to retire earlier, the state does not want to encourage earlier retirement. The Chancellor found that this choice of tax policy also falls within the scope permitted by the Constitution.

Taxation of the second pension pillar

A petitioner complained that the Tax and Customs Board did not provide an opportunity to deduct from the taxable income generated by payment of the mandatory funded pension a loss sustained from the transfer of securities. The Chancellor found that the decision of the Tax and Customs Board to refuse to refund income tax was legitimate.

Different rules apply to the taxation of second pillar disbursements than to the taxation of other investment income. Contributions to the second pillar have been deducted from a person's taxable income (and part of those contributions is social tax), which is why it is understandable that the Riigikogu has regulated taxation of disbursements differently from taxation of other investment income.

The Riigikogu may establish different tax rules for each type of investment, otherwise the parliament would not be able to create special taxation schemes.

Taxation of compensation for non-pecuniary damage

The Chancellor was asked to check whether it was constitutional to subject non-pecuniary damages to income tax. Under § 12(3) of the Income Tax Act, compensation for non-pecuniary damage paid by the state or local authority or awarded by a court is not treated as income of a natural person.

The Chancellor asked the Minister of Finance to explain why non-pecuniary damages are exempt from tax if awarded by a court, but income tax must be paid on damages paid under an out-of-court settlement.

In the opinion of the Minister of Finance, the exemption of all non-pecuniary damages from income tax would create the risk that transactions that are currently subject to income tax might be carried out by mutual agreement under the name of such damages. The Minister agreed that it is not right to favour a situation where a person has no interest in agreeing to

an out-of-court settlement, since in that case income tax is payable on the damages. The Minister of Finance promised to analyse the issue and prepare the necessary amendments to the Income Tax Act.

The impact of nature conservation on the income base of local authorities

The Chancellor was asked to assess whether it was legitimate for the state to have failed to compensate local authorities for land tax that is not collected from nature reserves.

The Chancellor found that rural municipalities and cities did not have a legitimate expectation to be compensated for the loss of tax revenue resulting from any change in the tax element. There is also no right to assume that the share of tax received by rural municipalities or cities will always remain the same. The state has the obligation to ensure sufficient funding to rural municipalities and cities so that they can perform the functions of self-government (§ 154(1) Constitution). In addition, local authorities are entitled to receive money from the state budget for the performance of state functions assigned by law (second sentence of § 154(2) of the Constitution).

The state may reduce the amount of money allocated for the performance of municipal functions if a local authority is still able to perform these functions to the minimum extent necessary.

Unemployment allowance and sickness benefit

Income tax refund and unemployment allowance

The Chancellor was contacted by an individual who was denied unemployment allowance because they had been refunded overpaid income tax for the previous calendar year.

The Estonian Unemployment Insurance Fund may suspend or terminate payment of unemployment allowance if a person's monthly income exceeds the amount equal to at least 31 times the daily unemployment allowance rate. Unemployment allowance is linked toactual need for assistance. If an unemployed person's income is equal to or greater than the established minimum, payment of unemployment allowance is suspended for 30 days(§ 32(1) 4) Labour Market Services and Benefits Act). Unemployment allowance is paid for atotal of up to 270 days (§ 30(1)) and the number of days on which the person is entitled to unemployment allowance does not decrease. Thus, payment of unemployment allowance may be spread over a longer period.

Employer's voluntary sickness benefit and social tax liability

In the event of an employee's illness, initially their replacement income is guaranteed by the employer and then by the Health Insurance Fund. Sickness benefit paid by the employer can be conditionally divided into two parts. The first part is mandatory sickness benefit (70 per cent of the employee's average wage) and the second part is voluntary sickness benefit, which the employer can pay up to the employee's average wage beginning from the second day of illness until the day when the Health Insurance Fund starts paying compensation to the sick person.

There is a special scheme for payment of sickness benefit to pregnant women. From the second day of illness, they will be paid sickness benefit by the Health Insurance Fund. The amount of sickness benefit is 70 per cent of the income subject to social tax in the previous calendar year. An employer cannot pay sickness benefit to an employee who has fallen ill during pregnancy. If an employer were to pay sickness benefit to a pregnant employee at the same time as the Health Insurance Fund, the employer would have to pay social tax on this remuneration. If a woman were to receive income subject to social tax at the same time as the Health Insurance Fund sickness benefit, she would lose her right to health insurance benefit. This places a pregnant employee in a worse position than employees to whom the employer has also decided to pay voluntary sickness benefit.

No reason exists for worse treatment of a pregnant employee. If the state has decided to build the system of sickness benefits so that, in certain cases, it allows maintaining an average income for a sick worker, then all employees who have fallen ill must be able to take advantage of this opportunity.

The Chancellor made a proposal to the Riigikogu to amend the law and allow pregnant workers to maintain proportionally the same replacement income as the rest of the insured persons to whom the employer pays voluntary sickness benefit. The Riigikogu supported the Chancellor's proposal.

Mitigating price increases

Support to cover the costs of rising energy prices

From 1 October 2022 to 31 March 2023, support was paid to people to mitigate the effects of rising energy prices. However, not all people received support to cover the costs of heating their homes, but only those whose homes are heated by electricity, gas or district heating. Heating costs were not compensated to those heating their homes with, for example, wood, pellets or liquid fuel, and therefore people deprived of support turned to the Chancellor.

The Chancellor found that the state is entitled to decide what measures to take in the event of an increase in the price of energy. Many people could be helped quickly with automatically paid support. Automatic support could be paid to cover the costs of heat and electricity sold via the network, but not, for example, to cover the cost of firewood. In some cases, unequal treatment may be justified by the complexity of administration.

If someone cannot cope with their home heating costs, they can apply for support from the local authority of their place of residence. Heating costs are also taken into account when paying subsistence benefit.

Support paid to mitigate restrictions

The Chancellor participated in two constitutional review court proceedings initiated by the courts concerning support paid to mitigate the coronavirus restrictions.

One case concerned the treatment of undertakings who applied the special VAT scheme for travel services. Tour operators who made use of the special scheme complained that, in payment of support, they were treated less favourably than other tourism operators who did not apply the special scheme. When applying for support, the reduction in turnover during the period of restrictions had to be proved on the basis of VAT returns. Since the declarations of the operators applying the special scheme for the taxation of travel services do not reflect actual turnover but the average profit margin calculated on the basis of data from previous

tax periods, it was impossible for the petitioner to satisfy the requirement.

The Chancellor found that there was no reasonable or appropriate reason for unequal treatment of undertakings that had implemented the special scheme. Differential treatment may in some cases be justified by the complexity of administration of support, but the state has failed to indicate what that complexity is for this group of undertakings. For instance, it is not clear how it would be more difficult to determine the turnover of undertakings which have applied the special scheme on the basis of their sales revenue than to carry out similar work in the case of undertakings which are not liable to account for VAT.

The Supreme Court took a similar view.

The second case concerned support for accommodation undertakings paid where reduction in turnover had been established on the basis of the VAT returns of undertakings liable to account for VAT. The Chancellor found that there was no appropriate and reasonable reason to treat undertakings in essentially similar situations differently.

The Supreme Court also took the view that the regulation allows for unjustified unequal treatment of accommodation undertakings that are subject to VAT. The court refuted assertions by the Minister of the Economy that paying support based on labour taxes would make administration much more difficult. The Court held that, in the instant case, ease of administration was not a sufficiently compelling reason to justify such a difference in treatment between sustainable and functioning accommodation establishments.

Previously, the Chancellor has resolved petitions concerning measures to alleviate the coronavirus restrictions which were submitted to contest the conditions regarding wage support, extraordinary operating loan, support for accommodation establishments, partial compensation for decreased turnover of accommodation establishments, support for catering establishments, support paid to operators of international regular bus services, support to tour operators, support to artistic associations and wage compensation for sole proprietors.

Recording the minutes of statements

Questions arose in connection with statements given to the Tax and Customs Board. A petitioner claimed that the Board had prepared the answers written down as their testimony even before questioning took place. The petitioner signed the minutes but, because of the large volume of text, they were unable to read the minutes before signing and, therefore, did

not raise any objections as to their answers.

It was no longer possible for the Chancellor to establish what actually happened when the statements were taken. At the same time, the Chancellor pointed out that if the Tax and Customs Board indeed pursues the practice that auditors prepare possible answers of interviewees before taking statements, the tax procedure may not be honest, objective and impartial, or leave the impression of an honest, objective and impartial procedure. The Tax and Customs Board affirmed that this was not their standard practice.