Tax Alert

Estonia, Issue 12, August 2009

AS PricewaterhouseCoopers in Estonia helps clients in finding tax efficient business solutions and managing tax risks.

We work together with our colleagues in other PricewaterhouseCoopers' offices world-wide and use our access to international know-how and long-term experience to quickly and efficiently solve tax issues that arise both locally and in foreign jurisdictions.

For more information, please see our contact details below.

Double tax treaty concluded between Estonia and Israel

On 29 June 2009, Estonia and Israel concluded a treaty for the avoidance of double taxation with respect to taxes on income. Tax treaty generally follows the wording of the OECD Model Tax Convention, which is a basis also for the rest of the Estonian tax treaties. Most significant aspects are as follows:

- Treaty provides that the competent authorities shall settle the question of dual residence of legal entities by mutual agreement. The protocol to the treaty further provides that to settle the question, competent authorities shall have regard to such factors as the place of effective management, the place where the entity was incorporated or otherwise constituted and any other relevant factors. Protocol further clarifies that as soon as Estonia would start using place of effective management criterion for the determination of residence under the domestic legislation, this would also be taken as a basis of determination of residence in the treaty concluded between Estonia and Israel.

- Treaty limits withholding tax on dividends to 0% provided that the shareholder is a company holding directly at least 10% of the capital of the company paying the dividends and 5% in all other cases. Dividends are, inter alia, exempt from withholding tax if it is paid to a pension fund or other similar institution providing the pension schemes, where such pension fund or other similar institution is established and controlled in accordance with the laws of the source state. As Estonian domestic legislation does not provide for a withholding tax on dividends, the treaty will not affect the dividends paid from Estonia to Israel;

- Treaty limits withholding tax on interest to 5%. Interest is exempt, *inter alia*, from withholding tax if it is paid to a pension fund or other similar institution providing the pension schemes, where such pension fund or other similar institution is established and controlled in accordance with the laws of the source state. As Estonian domestic legislation does not provide for a withholding tax on arm's length interest, the treaty will generally not affect the interest paid from Estonia to Israel;

- Treaty provides that the royalties are taxable only in the state where the recipient is a resident. Therefore, the treaty limits Estonian rights to withhold tax on the royalties paid to Israel (under domestic legislation royalties are subject to 10% withholding tax).

Treaty will enter into force after the parties have notified each other on the completion of the respective domestic procedures (e.g. ratification in Estonia).

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Legal chancellor questions the constitutionality of the VAT rate increase

On 23 July 2009 the Legal Chancellor stated that the amendments to the VAT legislation, effective as of 1 July 2009, are not compatible with the Constitution as they do not leave sufficient time for the taxpayers to adjust their activities to the new circumstances related to the VAT rate increase. Legal Chancellor made a suggestion to the Parliament to bring the provisions relating to the VAT rate increase in line with the Constitution.

As for the background, the Parliament adopted on 18 June 2009 the law, which increased the standard VAT rate from 18% to 20%. President pronounced the law on 22 June 2009 and the law was published in the State Gazette on 26 June 2009. The rate increase became effective as of 1 July 2009. Legal Chancellor found that such a short notification period regarding rate increase - leaving the taxpayers only 4 days, out of which 2 days were holidays, to adjust their activities to the new circumstances - is incompatible with the constitutional provisions granting freedom of entrepreneurship and the legal certainty. Legal Chancellor concluded that VAT rate increase should be notified sufficiently in advance. Not providing sufficient time to adjust their activities may have given rise to negative consequences to the taxpayers.

On 3 August 2009 the Parliament decided that they do not agree with the position taken by the Legal Chancellor as his analysis is concentrated only on insufficient notification period and has not taken into account the state budget situation - that such quick changes were necessary to stabilize the weak budgetary position of the State. However, the Parliament still initiated the draft law (see next item), which provides for implementation rules to soften the effects potentially arising from the increase of tax rate due to too short period of notification.

Legal Chancellor indicated that he would like to examine the new draft law to evaluate whether it provides remedies to the problems he has identified. Thereafter, he can decide whether to forward the issue to the court, who would make the final decision whether the insufficient notification period provided for the tax rate increase is compatible with the Constitution or not.

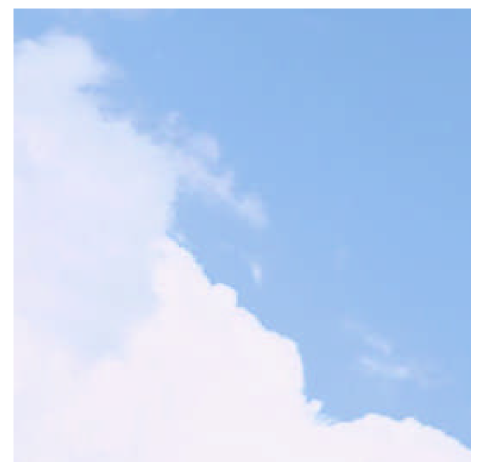
Draft law providing the implementation rules for the rapid VAT rate increase

In relation to the problems indicated by the Legal Chancellor (see previous item), the Parliament initiated on 3 August 2009 the draft law which provides for implementation rules to soften the effects potentially arising from the rapid increase of tax rate.

Among other issues the draft provides that:
- If the services are provided for the period longer than the taxable period, it is allowed until 31 December 2009 to invoice and account for VAT for services provided until 30 June 2009 using the 18% tax rate;
- Tax return for July may be submitted to the tax authorities by 31 August (instead of 20 August as provided in the law) without the negative consequences from the tax authorities;
- Sole proprietors using the cash-basis accounting may use the 18% tax rate in respect of the invoices submitted before 1 July 2009 if the goods were dispatched or made available or if the service was provided before 1 July 2009, but the cash is collected after the 1 July 2009.

Additionally the draft provides that the seller or provider may charge until 31 August 2009 1.7% higher prices that indicated on the packages, price lists or any other similar document. Similar principle may also be used by the service providers, whose prices are under the law subject to the mandatory confirmation by the authorities, on the conditions that the confirmed prices included the VAT.

The Parliament will convene to discuss the draft law on 31 August and on 1 September. If the law will be adopted, it will be retroactively applied as of 1 July 2009.



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