Tax Alert

Estonia, Issue 15, November 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.

TAX LEGISLATION

Deductibility of study loan interest and trade union membership fees abolished

On 29 October 2009, the Parliament adopted the changes to the Income Tax Act. With these amendments resident individuals would no longer be entitled to deduct interest paid on study loans from their taxable income. In addition, resident individuals would no longer be able to deduct entrance and membership fees of trade unions from their taxable income.

The amendment does not concern individuals, who have paid interest, entrance and membership fees in 2009 and would like to use their deductions in the tax return submitted on 31 March 2010. The amendment is important for the individuals who will make mentioned payments as of 2010.

Further planned amendments in the Income Tax Act

On 16 November 2009, the Ministry of Finance disclosed the new version of the draft of the Income Tax Act that was initially disclosed in August 2009 and which provided for several amendments in respect of taxation of individuals and legal entities as of 1 January 2010. The high level overview of the planned amendments was brought to you in our previous Tax Alert from September (No. 13). The most important differences in the old and new version of the draft are as follows:

- The enforcement of the law will be postponed from 1 January 2010 to 1 January 2011.
- Under the old draft the exemption in respect of capital gains from the sale of private dwelling was planned to be tied with the condition that the dwelling has been registered for the 12 months during last two years in the Population Registry as the main residence of the person. The new draft drops such condition.
- The new draft provides that any benefits given to the employees by the companies belonging to the same group with the employer, will be considered as fringe benefits given by the employer and taxed as such. In the old draft, such rule was not limited to the group companies, but to benefits given by any related party.

We hope to bring a more detailed overview of the changes to you as soon as the law has been adopted by the Parliament.

CASE LAW

The Estonian Supreme Court elaborates the basis for implementing the substance over form principle (known as the "Hansapank case")

On 4 November 2009, the Supreme Court delivered rulings in cases No 3-3-1-52-09 (Leeman) and 3-3-1-59-09 (Ilvest), concerning the situation whereby prior to the sale of shares to a third party, the resident individual shareholders contributed their shareholdings to their personal holding companies. The Supreme Court ruled in favor of the taxpayers.

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Due to the distinctive features of the Estonian tax system, income received by resident individuals is taxable at the moment of receiving the gain whilst taxation of income received by resident companies may in principle be deferred indefinitely (companies become subject to income tax at the moment of profit distribution). The major difference in the timing of taxation between individuals and companies may influence the individual shareholders to contribute their shares to a holding company before the sale of their shareholdings.

Pursuant to the circumstances of the case, the shareholders had contributed their shares in AS Hansapank (a major Estonian bank) to their holding companies knowing already that FöreningsSparbanken AB (Swedbank) had made an offer to the minority shareholders to purchase all their shares. Following that, the companies, controlled by these individuals, sold the shares of Hansapank AS to Swedbank, a Swedish bank. The Estonian tax authorities claimed that the situation whereby shareholders contribute their shares to companies under their control prior to the sale transaction is conducted solely for the purposes of evading tax liability at the level of the individual. The tax authorities` reasoning was based on the substance over form principle (Law on Taxation § 84).

The Supreme Court did not consider the contribution of shares to companies under their control as tax avoidance referring to the § 15 Sec 4 p. 10 of the Income Tax Act that provides for a specific roll-over clause for non-monetary contributions. The Supreme Court's arguments allow to conclude that in such cases the taxation should generally take place at the moment when the shareholder sells the shares which were received as a compensation for its contribution. Likely there will be more case law on interpretation of general anti-avoidance clause where the exact borders of the applicability of § 84 of the Law on Taxation are clarified.

APPLICATION OF EC LAW

The European Commission refers Estonia to the Court of Justice over its discriminatory taxation of non-residents' pensions

On 29 October 2009, European Commission issued the press release (IP/09/1636) informing that Estonia has been referred to the Court of Justice over its discriminatory taxation of non-residents' pensions.

The case concerns non-resident pensioners with a modest global income which does not exceed the tax exemption allowances applicable to pensioners in Estonia (EEK 63 000 or ca EUR 4026).

If such taxpayers receive almost all their income in Estonia, they can benefit from the Estonian personal allowances and do not have to pay tax on their income. However, non-resident taxpayers who earned less than 75% of their global taxable income in Estonia cannot benefit from the personal deductions available to residents. The Commission considers that the restrictive application of personal allowances in the Estonian legislation constitutes a discrimination prohibited by Article 39 the EC Treaty concerning the free movement of workers, as the favourable treatment is not extended to non-resident taxpayers who are effectively in the same situation as resident pensioners.

On 17 August 2009, Estonia has proposed draft amendments to the Income Tax Law where such discrimination should be mitigated by allowing persons who earn less than 75% of their taxable income in Estonia to benefit from the personal deductions provided that they are able to prove that they cannot benefit from deductions in any other state. Although the draft previously provided for enforcement of changes as of 1 January 2010, with updated draft from November 2009 the Ministry of Finance has proposed to postpone the enforcement of the changes until 1 January 2011.

European Commission's press release is available at:
Http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1636&format=HTML&aged=0&language=EN&guiLanguage=en

European Commission has initiated an infringement procedure against Estonia in respect of real estate income received by non-resident contractual funds

According to the Estonian Ministry of Finance, a new infringement procedure has been initiated against Estonia concerning discriminatory treatment of real estate income received by non-resident contractual funds. Although the details of the infringement procedure are not public, it can be assumed that infringement procedure may relate to the discriminatory treatment of gains from the alienation of real estate, gains from the alienation of shares in a real estate company as well as rental income. All those are subject to 21% tax when received by foreign funds, while domestic contractual funds are exempt from any tax.

In principle, the arguments of this infringement procedure should largely be the same as the arguments used in the infringement procedure against Estonia in respect of the tax withheld on dividends paid to non-residents. Dividend withholding tax was abolished as of 1 January 2009.

Ministry of Finance proposes to amend legislation to end discrimination of foreign charities

On 17 August 2009, the Ministry of Finance has made public new draft amendments to the Income Tax Law which provide that the various forms of tax reliefs for donations made to the domestic charities will also be extended to foreign charities. Currently, Estonia offers various forms of tax relief for donations by resident individuals and resident companies. However, this favourable tax treatment is only granted if the charity is established in Estonia and is included in a special list. The amendment would allow the individuals to deduct from their taxable income the donations made to the qualifying foreign charities as well as allow companies to make tax exempt donations to such charities within the limits prescribed by the law. With the same draft, however, the beneficial treatment of donations that were earlier applicable also to certain bodies established by Estonian governmental institutions are abolished (instead of extending them to the similar institutions established by foreign governmental institutions).

The proposed changes are based on the European Commission infringement procedure (IP/08/1818 from 27 November 2008) requesting Estonia to end discriminatory treatment of foreign charities and certain bodies established by governmental institutions.

Although the draft previously provided for enforcement of changes as of 1 January 2010, with updated draft from November 2009 the Ministry of Finance has proposed to postpone the enforcement of the changes until 1 January 2011.

European Commission's press release is available at:

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Ministry of Finance proposes to introduce new interpretation in respect of exit tax provisions on permanent establishments

On 17 August 2009, Ministry of Finance has made public new draft amendments to the income tax law which clarify the determination of taxable profits and thus taxable "deemed profit distributions" by permanent establishments (due to the characteristics of Estonian corporate tax system the tax liability of permanent establishment has been deferred to the moment of "deemed profit distributions"). Although not directly provided in the changes to the text of the law, it is noteworthy that the explanatory letter to the draft provides that in calculation of profits attributable to permanent establishment, no unrealized profits will be taken into account. This means that a cross-border outbound transfer of assets is deemed to take place at the acquisition cost and not at the fair market value of the assets in order to avoid any exit taxation in respect of unrealized profits. Although Estonia could merely defer its taxing rights and claim them at later stage when assets have been realized abroad, it has been indicated that claiming taxes abroad would be too complicated and therefore Estonia would not use such right.

Accoding to the explanatory letter to the draft, the changes are made due to the infringement procedure started by the European Commission where Estonian attention has been lead to the potential exit taxation issue in Estonian income tax law. Estonian resident companies may freely transfer their assets from one domestic branch to another branch in Estonia or abroad whereas non-residents become subject to tax when assets are transfered out of permanent establishment located in Estonia (i.e. assets are deemed to be realized and tax liability created upon cross-border transfer).

Although the draft previously provided for enforcement of changes as of 1 January 2010, with updated draft from November 2009 the Ministry of Finance has proposed to postpone the enforcement of the changes until 1 January 2011.

The report of Ministry of Foreign Affairs on recent infringement procedures further provides that this infringement procedure on permanent establishments earlier also involved the discrimination of permanent establishments compared to resident legal entities. This issue was dropped due to the changes in the law from 1 January 2009. Until 31.12.2008 there was a problem that certain payments made out of undistributed profits, such as for example liquidation proceeds, were not subject to corporate tax at the level of resident legal entities, while any payments out of undistributed profits of permanent establishments, including payments on termination of permanent establishment, were always subject to corporate tax.

OTHER AMENDMENTS

Implementation of the Directive on the exercise of certain rights of shareholders

On 15 November 2009 the law amending the Commercial Code and other laws came into effect. The primary objective of the new law was to implement the Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies into the Estonian legislation. The aim of the said Directive is to grant

shareholders better access to information related to the general meeting and ability to exercise voting rights without physically attending the general meeting. The measures implementing these objectives are transfer of information related to the general meeting via electronic means, electronic participation in the general meeting, voting by correspondence or by electronic means and smooth and effective process of proxy voting.

Although the Directive addresses the rights that should be guaranteed to shareholders of companies whose shares are admitted to trading on a regulated market, Estonia has expanded certain rights to shareholders of companies that are not listed. Please find below overview of the more significant amendments introduced into the Commercial Code.

Listed companies may offer their shareholders any form of participation in the general meeting by electronic means provided that identification of the shareholders and the security of electronic communication is ensured. Notably electronic participation is deemed as real-time transmission of general meeting, real-time two-way communication enabling shareholders to address the general meeting from a remote location and mechanism for casting votes before or during the general meeting from a remote location without having to appoint a proxy holder who is physically present at the meeting.

Private and public limited companies that are not listed may offer their shareholders electronic voting provided that identification of the shareholders and the security of electronic communication is ensured and voting by correspondence before the meeting. The details of arranging the electronic voting are described in the Articles of Association.

The minimum required stake for shareholders to have the authority to summon a general meeting is dropped from 10% to 5% in case of listed companies. In such cases, the shareholders also have the right to put items on the agenda of the general meeting. As a general rule, shareholders representing more than 5% of the shares have the right to put items only on the agenda of the annual general meeting.

Listed companies are required to issue the convocation for the general meeting in a manner that ensures fast access to it on a non-discriminatory basis throughout the European Community. A listed company is required to publish all information related to the general meeting on its Internet site no later than on the 21 day before the day of the general meeting. The list of compulsory information to be published in the convocation is upgraded; some of the new requirements shall only be applicable to the listed companies and some to all companies. The party summoning the general meeting (in most cases the management board) will have the obligation to prepare draft resolutions in addition to the agenda of the meeting and submit these to the shareholders. Early preparing of resolution drafts will enable shareholders to prepare themselves better for the meeting since they already know what will likely be resolved.

Companies that are not listed may publish the documents related to the general meeting only on their company's Internet site. The procedure for appointing a proxy holder is facilitated, the requirement that the proxy holder is issued a proxy will be removed (shareholder may notify the company directly about appointing a proxy holder), furthermore, shareholders may appoint proxy holder by electronic means.

In addition to adopting the above amendments deriving from the Directive, amendments concerning termination of the mandates of the governing bodies of companies are adopted. Currently companies are entitled to remove management board members anytime without indicating a cause and whereby the agreement concluded with the board member will be terminated according to the terms and conditions as stipulated in the contract. This means that the law especially distinguishes the termination of the mandate of the board member to represent the company and the termination of the agreement concluded with the board member. However, the resigning of the board member is regulated differently, namely the board member is only entitled to resign upon indicating a just cause, whereby the law does not expressis verbis distinguish between termination of the mandate of the board member to represent the company and the termination of the agreement concluded with the board member. Amendments to the Commercial Code provide that resignation of the board member will be treated similarly to the removal of the board member. This means that the board member will be entitled to resign without having to indicate a just cause and the agreement concluded with the board member will be terminated separately, according to the terms stipulated in the agreement.

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