

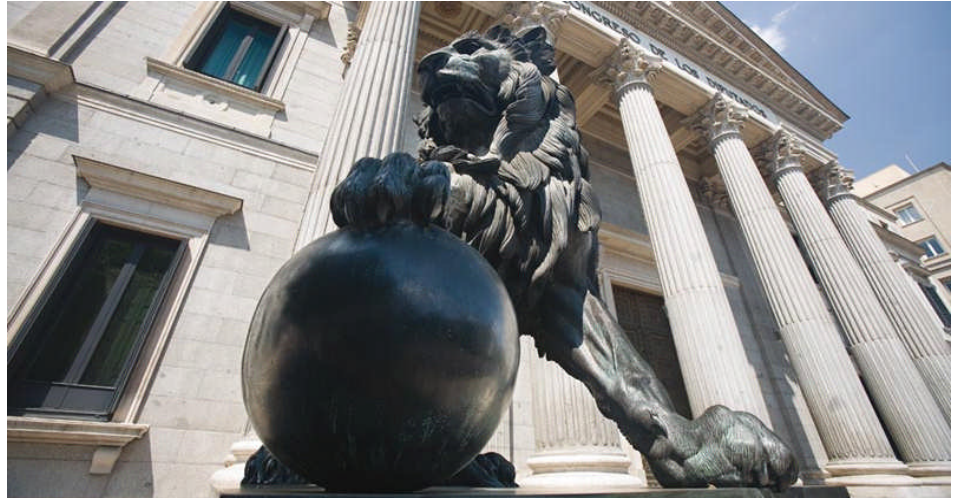
Tax Alert

Estonia, June 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.

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Court disagreed with reclassification of dividends to employment income

Estonian Supreme Court did not accept the tax authority's appeal for cassation as regards to the decision of appeal court from 4 March 2009 in case 3-08-364 which relates to the reclassification of dividends to employment income.

According to the factual background of the case, the Estonian Tax and Customs Board wanted to reclassify dividends paid by company to its sole shareholder as employment income. Their methodology was based on the average gross salary that companies in similar field of activity and with similar economic results had paid to their employees. The basis for the reclassification was Article 84 of the Estonian Taxation Act that provides for the substance over form principle.

Although the appeal court confirmed the application of the substance over form principle in Estonian tax legislation, the tax authorities were unable to convince the court that their methodology for calculating the taxable amount is appropriate. Court found that using average employment income as a comparable is not reasonable and would likely lead to unequal treatment of taxpayers.

In principle, Court referred to the poor quality of the activities of the legislator and the tax authorities, stating that it would have been their obligation to create the tax system that is understandable to a reasonable person and avoids unequal treatment. The tax liability must be understandable to the taxpayer in advance and a company must have some point of reference to estimate the amount of salary payable to the employee who is also a shareholder in order for the tax authorities to approve it. As tax authorities and legislator had not defined the formula which could have served as basis for calculation of employment income, it also cannot be done by the court as this could have not been foreseen by the taxpayer.

Decision of the appeal court can be considered as significant win for a taxpayer that supports the application of the principle of legal certainty in Estonian tax system and gives a direction to the legislator and tax authorities to put more emphasis on quality of drafting and implementing the tax laws.