Tax Alert

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

On 17 June 2009, the Supreme Court delivered ruling in case No 3-3-1-23-09, 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 Court ruled in favor of the taxpayers.

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 Sylvester (a major Estonian timber company) to their holding companies. Following that, the companies, controlled by these individuals, sold the shares to Stora Enso Timber Oy, a Finnish resident company.

The Estonian tax authorities claimed that the situation whereby shareholders contribute their shares to companies under their control prior to the sale transaction is economically unnecessary and unreasonable. Thus, the contribution of shares must have been 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).

1. Although the Supreme Court confirmed the continuous implementation of the substance over form principle in the Estonian legal order, it delivered that in the given case the tax authorities had not identified the subjective side of the transaction. The Supreme Court clarified that in order to implement § 84 of the Law on Taxation, the tax authorities have to identify the taxpayer's subjective considerations for conducting the transaction, i.e. the taxpayer's activities have to be aimed at distorting the form of the transaction in order to evade taxes. In the verdict the Court provided examples of factors which should verify the lack of economic substance of a transaction (paragraph 15 of the verdict).

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2. The Supreme Court repeated its position from a previous verdict (from 6 November 2008, case No 3-3-1-57-08) that in order to qualify the gain received from the sale of shares at the level of the company as the gain received at the level of the individual "it should be substantiated how the assets of the individual increased on account of the gain received by the company and how the individual is able to use the gain received by the company to his/her benefit" The Supreme Court concluded that the tax authorities have not determined that the individuals have received gain in the meaning of § 15 (1) of the Income Tax Act, i.e. that the gain received by the company was actually at the disposal of the individuals or that there were other circumstances which would lead to believe that in fact the benefits were realised by the individuals at the level of the company.

3. The Supreme Court also clarified the issue of bindingness of clarifications issued by the tax authorities before the regulation on binding advance rulings came into effect, in the situation where the tax authorities had initially given an explanation and later changed their position and administrative practice. In the given case, the shareholders had applied for clarification of the tax consequences of the future transaction and had received a positive answer. Despite the fact that at the time the Estonian legislation did not provide for binding advance rulings, the Court said that already in year 2002 the tax authorities were forbidden from influencing tax payers to act in a manner which is not in accordance with the laws. The Court stipulated that the clarification issued by the tax authorities might have provided the shareholders the necessary certainty to act and that the shareholders may have planned their activities based on this clarification, thereby trusting the correctness of the tax authorities` position.

The Supreme Court`s ruling may be viewed as another affirmation of implementation of the legal certainty principle in the Estonian legal order, limiting the ways the tax authorities are entitled to implement the economic substance over form principle.

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