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Hidden profit distributions and reporting loans

The Tax and Customs Board has published new guidelines regarding the tax treatment of loans deemed to be hidden profit distribution as of January 1, 2018. See the guideline https://www.emta.ee/et/ariklient/tulu-kulu-kaive-kasum/tsd-muudatused-2018-aastal/varjatud-kasumieraldise-maksustamine.

In addition, in December 12, 2017 the Ministry of Finance amended the Regulation No 60, the amendments will come into force as of January 1, 2018. As a result, it is now clear how and where the loans granted and repaid should be reported as well the reporting requirements of loans treated as hidden profit distributions and repayments of such loans.

Form INF 14

As of January 1, 2018, the current form INF 14 will be renamed and among other things loans granted to related parties and repayments of such loans will be reported there. The name of the form INF 14 is going to be "Declaration of compensation for use of a private car, training and health improvement expense and loans granted".

Table IV will be added to the current INF14 form where the quarterly accounting of such loans and repayments will take place (by recipients and types). The interest received will be reported as well. Loans will be classified into three categories: (classical) loans, loan granted under cash pool agreements and other transactions equivalent to loans (such as overdrafts, deposits).

The first INF14 will be filled for longer period than one quarter, as in addition to loans granted and repaid in the 1st quarter of 2018, the loans granted and repaid within the period from July 1, 2017 to December 31, 2017 have to be reported as well in accordance with the transitional provision (Income Tax Act (ITA) § 61 (54)). A loan that was granted under a loan agreement before July 1, 2017, but has been increased or the repayment deadline has been extended during this period, is also subject to reporting. The first INF 14 should be filed no later than April 20, 2018. The reporting obligation applies also to permanent establishments of resident and a non-resident companies (no reporting obligation for banks and public limited liability funds).

It should be noted that only the loans issued (cash-bases) to parent and so-called sister companies will be subject to the reporting obligation.

Guidelines from the Tax and Customs Board

By comparing the wording of § 50^2 (1) of ITA as of January 1, 2018 with the guidelines prepared by the Tax and Customs Board, it appears that the Tax and Customs Board, with the approval of the

Ministry of Finance, is interpreting this provision rather in favor of the taxpayer as not every loan granted to a shareholder could be treated as a hidden profit distribution, but only loans issued to

- **the parent company or**
- **another subsidiary of the parent company (sister company)**

In case the terms and conditions of such loan agreements and the use of the loans indicates that there is no intention or no virtual ability to repay the loan, the loan should be considered to be a hidden profit distributions.

Thus such interpretation excludes loans granted to the lender's shareholder who, in the meaning of the Commercial Code § 6, is not considered to be a parent company, from the scope of Income Tax Act § 502 (1). For example, if the majority shareholder (holds more than 50%) is an individual as an individual may not be a parent company, as well as shareholders whose holding based on voting rights is equal to or less than 50%.

The Tax and Customs Board point of view is that the provision of taxation of hidden profit distributions assumes that the lender belongs either to a holding group (the most common situation based on voting rights has to have more than 50% of the votes, directly or indirectly, see the §6 (1) of the Commercial Code); a contractual group (assumes having a shareholding and control under an agreement, see § 6 (2) of the Commercial Code) or a factual group (assumes having a shareholding and factual control, see § 6 (2) of the Commercial Code).

When is a loan treated as a hidden profit distribution?

According to the guidelines issued by Tax and Customs Board, a loan granted to a parent or a sister company is considered to be a hidden profit distribution, in case the repayment of the loan is unlikely or virtually impossible or that there is ground to believe that by granting the loan it was intended to avoid or to reduce income tax liability, for example:

- lending for an unreasonably long period (over 5 years);
- an unreasonable repayment schedule;
- repeatedly extending the repayment deadline or increasing the loan amount;
- the loan amount depends on the size of the profit (for example, situations in which each year a loan of the same amount as the subsidiary's profits is issued to the parent company);
- the borrower's use of the loan clearly indicates the inability to repay the loan;
- not paying any dividends.

Burden of proof

In case the loan repayment period is longer than 48 months, the taxpayer is be obligated to prove the ability and the intention to repay the loan at the request of the tax authorities. Thus, it can be concluded that, in case the tax authority require taxation of loans granted for a period shorter than

48 months, the tax authorities are required to prove the contrary (the inability to repay the loan and the lack of intention of doing so).

Taxation of the hidden profit distributions and reporting

Hidden profit distributions are subject to 20/80 CIT and reported by taxpayer in TSD annex 7 using the code 7012. The recipients of the hidden profit distributions are reported in form INF1, the type of income is VKE. Therefore, as of January 1, 2018 the name and the structure of the forms TSD annex 7 and INF 1 will changed as well.

Repayment of taxed loan

In case a loan that was previously taxed as a hidden profit distribution is repaid fully or partially, the income tax paid will not be refunded, however, the company gains a right to pay tax-free dividends (Income Tax Act § 50 (1^1) 7)). In order to pay tax-free dividends, the repayment of once taxed loans should be reported in part 2 of the TSD annex 7 using the code 7211.

An example of a more complex holding group and reporting

Company A has a 60% shareholding in companies B, C and D and a 20% in company G.

Company B and C each have 60% shareholding in company E.
Company D has 60% shareholdings in F and a 20% in G.
Company E has 20% shareholding in G.

A group can only have a one parent company. In this case, A is the parent of all the companies; B, C and D are its direct subsidiaries, and companies E, F and G indirect (for example, E has 30% of the votes in B and C, therefore A has majority of votes and thus E is A´s subsidiary).

Therefore, loans granted to A by B, C, D, E, F or G are subject to reporting in the form INF 14 and could be potentially subject to CIT. The same rules apply to loans granted for example by E to another A´s subsidiary, for example to C or G.

Draft law for amendments to Value-Added Tax Act

The Parliament of Estonia is in the process of adopting a draft law of the Value-Added Tax Act (VAT Act) complied by the Ministry of Finance.

The concept of plot is replaced by construction land

Under the current VAT Act the sale of land is subject to VAT in case the land is a plot that has an approved zoning plan and construction rights provided there are no buildings located on the plot.

According to the Ministry of Finance, the current definition of the tax object depends on the existence of a zoning plan and thus does not allow taxation of all land that are essentially considered as building land which taxation the VAT Directive requires. A zoning plan is not always required for construction works. In the judgment of Court of Justice of the European Union it is mentioned that when defining „ building land“ member states should follow the definition in the Article 135 (1) 1) of the VAT Directive, which seeks to exempt from VAT only supplies of land which has not been built on and is not intended to support a building (C-543/11 (30)).

In addition, a civil engineering work is also considered to be a construction and therefore, a land plot with an approved zoning plan for construction works which does not have buildings, but has a civil engineering work (for example a land cable with a connection plate or a road) is not currently subject to VAT. However, it is possible to opt for VAT by submitting a notification to the Tax and Customs Board prior to the sale. Thus this enables to avoid taxation of a land plot intended for construction works.

According to the draft law, instead of a plot a new concept called "building land" will be introduced to the VAT Act and is defined as follows: "Building land as defined in the General Part of the Civil Code Act is an immovable property without buildings, which according to its design specifications, zoning plan or a state or local government special spatial plan is designed for construction or for which a building notice has been submitted or for which intended use of cadastral unit is residential or business land. "

Based on the above, it can be concluded that:

1. a land without buildings planned for construction works that has a civil engineering work, is subject to mandatory taxation;
2. building land is any type of unimproved building land planned for buildings (with detail plan, special spatial plan, design specifications, submitted building notice);
3. in case a land, with an intended use of commercial or residential land, is sold, this land is considered to be equal to building land and is subject to taxation.

According to the draft law, the amendment should enter into force as of September 01, 2018.

Some metal products are exempt from reverse charge

The draft law proposes to exclude the following from Value-Added Tax Act § 41^1 (2) 5):

- metal products with the code 721691 (flat-rolled products, including profiled sheets) and
- certain pipes (ventilation, aspiration, smoke and drainpipes) since no VAT fraud has been detected in the course of selling these products.

Thus the sale of these goods will be taxed under the general rule (i.e no domestic reverse charge mechanism will be applied) as **from April 1, 2018**.

Reverse charge mechanism and invoices

Currently, when goods subject to domestic reverse charge mechanism are sold it is required to issue a separate invoice with the reference to reverse charge. This requirement will be mitigated. In the future, there is no need to provide a separate invoice when goods and services subject to the general and special arrangements are sold together, however, the goods subject to reverse charge mechanism have to be separately brought out.

If during the time of issuing the invoice, a sale subject to reverse charge mechanism has not yet taken place (no goods have been transferred, no money has been received) then a separate invoice with a reference to reverse charge has to be issued.

The amendment should enter into force as of April 1, 2018 according to the draft law.

The right to deduct input VAT is not limited if the seller is not registered for VAT

The Supreme Court has made an interesting decision in favor of the taxpayer concerning the limitation of deducting input VAT (Case No. 3-15-838 /22).

The buyer purchased services and deducted the input VAT based on an invoice issued by the seller (during the period from April to July 2014), at the time the seller was no longer registered for VAT (was deleted from the register March 31, 2014). The Tax and Customs Board denied the buyer to deduct input VAT as the buyer had an obligation to check whether the seller was registered for VAT or not. If the seller was not registered for VAT, the buyer was not entitled to deduct input VAT. The buyer argued that he had been doing business with the seller since 2013 and he did not check the VAT registration every time when making the payments. The Tax and Customs Board did not take the buyers argument into consideration.

The Administrative and Circuit Court agreed with the Tax and Customs Board’s position. The Circuit court added that the buyer has the option to contact the seller for the seller to return the VAT paid by the buyer and if the seller does not do so, the buyer has the right to reclaim it in a course of a civil proceeding. The Circuit Court stated that registration for VAT is a substantive condition for the deduction of input VAT.

On the contrary, the Supreme Court found that the tax authorities had no grounds to limit the buyer´s right to deduct input VAT.

The Court referred to various judgments of the European Court of Justice, according to which the right to deduct input VAT cannot be made dependent and the buyer's right to deduct cannot be denied solely on the ground that the seller is not registered for VAT in a situation where the invoice contains all the information allowing to identify the subject matter and the occurence of the transaction between the buyer and the seller.

However, the abovementioned applies only in case there is no doubt whether the transactions have taken place between the buyer and the seller and that the invoice meets the invoice requirements necessary to deduct input VAT. If the tax authority has evidence that allows to question the bona fides of the buyer or indicate the buyer may partake in a VAT fraud, the Tax and Customs Board has the opportunity to issue a tax assessment to the buyer.

If there is no such suspicion or evidence, the seller is required to pay the VAT added to the state budget pursuant to § 3 (6) 2) of the VAT Act. However, it is questionable whether the Tax and Customs Board is able to enforce the seller to pay the VAT to the state budget considering that the seller has been deleted from the Commercial Registry as of July 21, 2017 in this instance.