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.

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Legal acts

Significant Supreme Court rulings on taxation

The Estonian Supreme Court has given two new rulings on taxation of consulting and management fees paid to a personal service company (so-called 'one-man business'). In both cases the court ruled that the tax authorities were correct to reclassify the service fees as employment income and charge employment taxes accordingly.

Sirowa v. Tax and Customs Board

The first case (no. 3-3-1-25-15; 11 September 2015) dealt AS Sirowa Eesti's ('Sirowa') appeal against the Tax and Customs Board. In 2005, Sirowa contracted three private limited companies for provision of variety of consulting and directorship services. The three individuals who were rendering the services on behalf of the companies were nominated as members of the board of Sirowa. These individuals had been directly employed by Sirowa immediately prior to concluding the company contracts. Each of the contracted companies was controlled by the respective individual (i.e. member of the management board of Sirowa).

In 2013, as a result of a tax audit, the tax authorities issued a tax assessment notice to Sirowa informing the company that the three service contracts with the private limited companies on provision of consulting and management services were essentially employment contracts and therefore the fees paid under those contracts must be taxed as employment income. As per assessment, Sirowa was obliged to pay employment taxes (income tax, social tax, unemployment and mandatory funded pension insurance contributions) on the service fees (before VAT) and repay the deducted input VAT.

The tax authorities argued that though formally the members of the management board, the main duties of the individuals were those of a CEO, a CFO and a chief accountant respectively, just as they had been before restructured arrangements. The authorities supported their position by the facts that the premises and the equipment necessary for the work was provided by Sirowa, the work was done within Sirowa office hours and there was a clear presence of subordination as well as uncustomary lack of service reports.

The tax authorities concluded that the service contracts with the limited liability companies were ostensible under article 83 (4) of Taxation Act and were merely concluded with the purpose to disguise the continuous employment relationship between Sirowa and concerned individuals.

The Supreme Court agreed with the conclusions of the Tax and Customs Board and the lower courts. It is possible to reclassify a service contract as an employment contract under article 83 (4) of Taxation Act if it is demonstrated that a corporate service engagement actually represents an employment relationship. According to the labour law, an employment contract can only be concluded with an individual, therefore such reclassification

automatically replaces the corporate contractor with the individual.

The Supreme Court also found that it was correct to use the service fees before VAT as the tax base and not to include the employment taxes in the service fees as was suggested by Sirowa. It is not possible to consider the reclassified service fees as gross remuneration since Estonian tax legislation does not allow employers to transfer their tax liabilities to employees.

Bauhof v. Tax and Customs Board

The second case (no. 3-3-1-12-15; 6 October 2015) focused on similar dispute between Bauhof Group AS ('Bauhof') and the Tax and Customs Board: Bauhof contracted one-man companies for provision of management and/or consulting services and the tax authorities reclassified the service fees paid under these contracts as director's fees and employment income.

In general, the key points of the Supreme Court's decision repeated the positions provided in earlier cases (Sirowa case and case no. 3-2-1-82-14 from 12 May 2015). However, in this case the court's resolution included a significant addition as to whether or not it is possible to contract another company for directorship services (director's fee is paid to a company and not to the nominated individual). The court held that an engaging company cannot be taxed merely on the basis of the fact that it outsources its directors from a corporate contractor. The court held further that contracting another company for directorship services can be justified and accepted, for example: when a group of companies sets up a management company that employs individuals whose duties include undertaking the positions of the members of the boards of the group companies or providing counselling services; or, when members of the board or the council do not act on a daily basis, the equipment necessary is provided and related costs are covered by the company providing the service; or, if a member of the management board or council has been appointed for a short term or has been appointed as such for several companies simultaneously (e.g. liquidators or trustees in the case of bankruptcy).

In the light of these rulings we recommend reviewing any arrangements with the consultants or the members of the management board or council where the remuneration for the services is not paid to the individual but to a company which is under the control of that individual. It may be presumed that the recent success in case law encourages the tax authorities to expand their field of revision of such arrangements.

The relevant guidelines on taxation of service fees paid to one-man companies have been published by the tax authorities a few days ago and are available in Estonian at: http://www.emta.ee/index.php?id=37591

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