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 alert

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Legal acts

Amendments to the Income Tax Act

On 20 April 2016 the Parliament passed a Law on Amendments to the Income Tax Act (184 SE II) which transposes the amending Directive 2011/96/EU (Parent & Subsidiary Directive) into domestic legislation. The amendments aim to limit the application of participation exemption on dividends which are on-distributed on account of dividends received from a subsidiary in cases where the participation exemption is abused. In addition, the double non-taxation arising from the use of hybrid loans will be eliminated.

Entry into force and implementing provision

It is important to note that the provisions limiting the application of the participation exemption (ITA § 50 sections 1^3 and 1^4) will not become effective immediately, but as of 1 November 2016 and these stipulations are to be applied in accordance with the respective implementing provision [ITA § 61 (48)] only to payments made after 1 November 2016. The implementing provision therefore grants certainty for the taxpayer that the limitations to the participation exemption will not be applied to dividend distributions effected on account of dividends received before 1 November 2016 even if on-distributed at a later date.

Hybrid loans – ITA §50 new subsection 1^3

A hybrid loan is a financial instrument which has the characteristics of both debt and equity. Member States treat hybrid loans differently from a taxation point of view. Due to the mismatch in treatment, this can lead to a cross-border situation resulting in double non-taxation – for example this occurs if one Member State sees the transaction as a loan and allows an interest deduction from the company's corporate profits, whereas the recipient's Member State treats the payment as a profit distribution which has to be exempted under the Parent-Subsidiary directive.

In order to eliminate the mismatch, § 50 of ITA is amended with a new subsection 1^3as follows:

- If the source state treats the payment as a dividend (i.e. the payment is not deductible from profits), the exemption is applied to on-distribution in Estonia
- If the source state allows a deduction from taxable profits (treated as an interest), the exemption does not apply to on-distribution in Estonia

To ensure equal treatment between dividends received from the European Union and from third countries, the limitation also applies to dividends received from third countries. In addition, the restriction is also applied to profits taken out of a non-resident's permanent establishment that are based on dividends received through or on the account of the permanent establishment.

Going forward, a taxpayer declaring received dividends on TSD Annex 7 has to give a confirmation that the subsidiary does not have the right to deduct the dividend from its taxable profits. If needed, the taxpayer must be prepared to prove to the tax administrator that the preconditions for applying the exemption are fulfilled.

Implementation of the general anti avoidance rule - ITA § 50 new subsection 14

The new provision is worded as follows:

"Subsections 1^1 and 2^1 shall not be applied to an arrangement or a series of arrangements which are not genuine, because the main purpose or one of the main purposes is obtaining a tax advantage. The said subsections are applied to the extent that they are put into place for valid commercial reasons which reflect the necessary and appropriate economic content for such business activities.“

The wording of the new provision is rather complicated, but its objective is simple: to restrict the application of the participation exemption in cases where it is abused. Gaining a tax advantage is considered to be abusive. However, identifying the abuse is difficult in practice, therefore increase of disputes in this area can be expected.

According to the explanatory notes to the law, a situation is abusive for example if a subsidiary is established or acquired for the main purpose of (or as one of the main purposes) to on-distribute the profits of a subsidiary tax exempt as dividends or as capital repayments. It follows that the reasons for establishing or acquiring a subsidiary should be of a business nature and not tax driven. To give some examples of tax motivated reasons, these can be taking advantage of the tax treaty network or favourable tax rules of the country (of residence) to achieve a lower tax cost; using the subsidiary as a conduit for dividend payments etc.

The explanatory notes specify that determining the actual economic content is not necessary under the directive's general anti avoidance rule (unlike the existing principle of economic interpretation provided in § 84 of the Taxation Act where it is necessary). Therefore, if one of the main objectives of acquiring a subsidiary is gaining a tax advantage which is contrary to the purpose of the directive, then the tax administrator can disallow the use of the exemption by the company without having to reclassify the transaction.

Based on the above, questions are likely to arise when applying the rule specifically to holding companies. The explanatory notes provide that in this event, it should be assessed whether the holding company has sufficient economic substance (place of business, managing structure suitable for the activities, qualified personnel etc) needed for carrying out its functions or whether it is merely a letterbox company with the main purpose or one of the main purposes of passing on dividends and achieving the most beneficial tax outcome by using the treaty network and tax regime of the country of residence.

Legal acts

Planned increase in the threshold for the obligation to register as taxable person for VAT

The Government has in principle decided to increase the threshold for the obligatory registration as a taxable person for VAT from the current EUR 16,000 to EUR 40,000 starting from 1 January 2018. Before doing so, permission must be sought from the European Union, but the Ministry of Finance expects it will be received and of course then a draft bill should be initiated for amending the VAT Act in this respect.

The measure reduces administrative burden and is in a way a tax incentive for micro-enterprises. The companies that stand to gain most from this are the ones whose supplies are mainly the product of their own activities without any large scale input.