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. For more information, please see our contact details below.

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The Estonian Taxation Act allows a taxpayer to apply for an advance binding ruling regarding a specific contemplated transaction or a set of contemplated transactions. The precondition for applying for an advance binding ruling is that there should be objective uncertainty of whether and how a transaction should be taxed. It can be said based on the small number of summarised advance rulings that are published on the official webpage of the Estonian Tax and Customs Board[1] recently, that taxpayers' interest to receive an advance binding ruling has decreased compared to previous years.

Only five summaries of rulings have been published during the first half of 2016. We provide overview of two of the latest rulings to explicate how the tax authorities interpret specific Value-Added Tax and Income Tax Act stipulations in practice.

The mediation of an insurance payment is not a supply

The first advance ruling concerns the interpretation of Value-Added Tax Act (VATA) § 12(9).

The applicant requested an advance ruling to determine whether an insurance payment that is received from a client and paid forward to the insurer is considered a supply under the VATA.

1 http://www.emta.ee/et/ariklient/maksukorraldus-maksude-tasumine/siduvad-eelotsused/siduvate-eelotsuste-kokkuvotted

The applicant was planning on forwarding the insurance payment received from the client in the same amount to the insurer by entering it in its books in a suspense account. Unfortunately, the decision does not specify whether the insurance payment in question would be made through a lessor.

It was the applicant's viewpoint that when mediating an insurance payment of a good in order to hedge the risks related to the client, the applicant cannot be seen as providing an insurance service which in turn is considered a presumption for making a supply. Thus, the insurance payment collected from its client by the applicant and paid on to the insurer should not be considered as the applicant's supply.

The Estonian Tax and Customs Board agreed with the applicant and referred to VATA § 12(9) which states that the taxable value shall not include the amounts received from the acquirer of goods or the recipient of services as repayment for expenses incurred in the name and on the account of the acquirer or recipient which are entered in the books in a suspense account. The amount of the expenses in such case must be verifiable. In the opinion of the Tax and Customs Board, the provision mentioned above provides that when offering to mediate insurance services of goods, the applicant (i.e. the recipient of the payment) does not have to include the payment for the insurance services into its taxable supply if it is reflected in a suspense account and the corresponding amount of the mediated insurance payment can be proved.

Therefore, the Tax and Customs Board in essence took the position that the applicant acted as a mediator of an insurance payment rather than the retail sales agent for these services. Significant importance was also placed on the accounting treatment i.e. entering the payment in the suspense account (not as income nor cost) and ensuring that the cost is provable.

No relevance was attributed to whether the insurance agreement is concluded in the name of the applicant or the applicant's client. A more restricted interpretation of the provision would have also been possible, since VATA §12(9) prescribes that the mediated payment should be done both in the name of the other person (i.e. the client) and on the account of the other person.

Taxation of demerger transfers as liquidation proceeds

The second advance binding ruling is interesting from the perspective of interpreting the Income Tax Act (ITA) since it now appears that a demerger might not always be deemed tax neutral by the tax authorities.

Based on the circumstances of the application, the company (applicant) sold its subsidiary and the real estate it held, wound up its economic activities and was planning to effect a demerger to divide into three new business entities. The individual shareholders of the demerging entity would each become a sole shareholder of each new entity. The assets (cash) were to be divided proportionally to the shareholdings in the demerging company. As a result, the subsidiary would be left with no assets after the demerger and it would be dissolved.

The applicant *inter alia* requested the advance ruling to determine whether the distributed assets would be taxable with income tax as shareholders' income while the applicant himself was on the position that since it was a demerger by way of division in the meaning of the Commercial Code, the assets of the demerging entity could not be considered as income of the shareholders.

The Tax and Customs Board disagreed with the applicant's understanding that the described transactions would constitute a demerger by way of division and found instead that the situation was in essence a liquidation and liquidation proceeds paid to shareholders in its course is income of the shareholders. The justifications offered by the Tax and Customs Board were as follows:

The demerging entity has ceased its economic activities by selling its assets and it has fulfilled all of its obligations with the proceeds received from the sale. Therefore the only remaining asset that can be divided in the course of the demerger is cash. Based on the description of the transactions, it is evident that the purpose of this transaction is to liquidate the subsidiary. There appears to be no basis to evaluate the transaction as either a transfer of going concern or continuance of its economic activities in newly established entities as the economic activities of the subsidiary had ceased. Based on the principle of economic interpretation,

Legal acts

the transaction should be considered a liquidation, not a demerger. Therefore, the transaction's outcome is not a transfer of assets in the course of a demerger, but payment of liquidation proceeds.

Thus, according to the tax authorities, the proceeds received from the transactions should be taxed with income tax in the same manner as liquidation proceeds of any company. The basis for taxation is ITA §50(2) – a company deleted from the register shall pay income tax on the portion of payments exceeding the monetary and non-monetary contributions paid into the equity of the company (i.e. the part of net profit). If necessary, income tax is also due on the level of the individual shareholder under ITA §15(2) if the amount exceeding the acquisition cost has not been taxed in the hands of the demerging company.