

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.

Contacts:

Hannes Lentsius

E-mail: hannes.lentsius@ee.pwc.com

AS PricewaterhouseCoopers

Tax Services

Pärnu mnt 15, 10141 Tallinn, Estonia

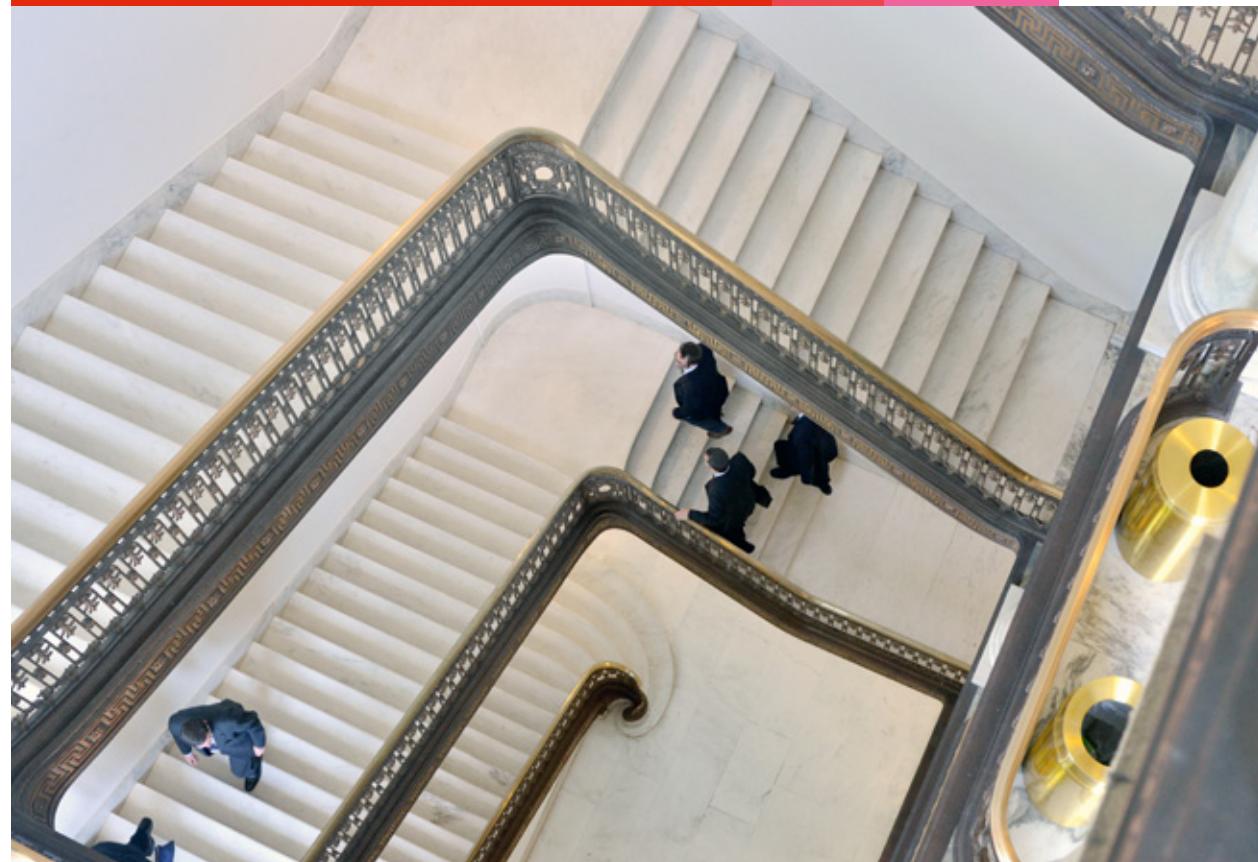
Tel: +372 614 1800

E-mail: tallinn@ee.pwc.com

www.pwc.ee

Tax alert

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The Government discusses issues relating to taxation of companies

The Ministry of Finance has published a tax memorandum intended for the government that contains an analysis and conceptual proposals on how and on which conditions the Income Tax Act should be amended in order to introduce a more favourable tax rate for companies regularly making profit distributions and how to limit taking out profits from Estonia in the form of loans.

Conditions for the 14% dividend rate and its effect on an individual's dividend income

The Ministry of Finance proposes that the preferential rate should be set at 14% and it would apply on the part of the distributed profit which is less or equal to the average taxable amount in Estonia in the preceding 3 years. It should be noted that profits not subject to taxation under the exemption method are not to be taken into account. This should encourage Estonian companies to distribute profits subject to income tax more regularly, potentially on an annual basis, rather than irregularly, meaning that one year dividends are distributed, but not in the following year, since that would not result in the 14% rate being achieved.

Therefore it is likely that in the near future a certain part of distributed profits is taxed with 14% at the level of the company, a part of it with

20% and a part is exempt from tax under the exemption method. The new system would become effective from 1 January 2018, but it has not yet been decided whether the first year that is taken into account for calculating the average distributed profits will be year 2018 or 2017.

In addition to the conditional decrease of the income tax rate upon profit distributions (14%), the Ministry of Finance has suggested that dividends paid to individuals, including those paid to non-resident individuals, should be taxed with income tax at the rate of 7%. This derives from the risk that otherwise an incentive is created for paying so-called "dividend salaries". Taxation would occur by way of withholding by the company making the payment. If dividends are taxed with a rate of 20%, then the withholding tax would be 0%. If the company distributes profits subject to both 20% and 14% tax rate, then tax is only withheld on the profits that are taxed with 14%.

For foreign sourced dividends received by an individual, it has been recommended to rather keep the current system in order to avoid double taxation (the so-called conditional exemption method).

Preventing hidden profit distributions (in the form of loans)

The Ministry of Finance has devised two alternatives that both aim to limit the total amount of non-taxable loans issued by a company and tax the exceeding amount with income tax. Alternative solution 1 is the so-called "pledge income tax" which is considered more effective and is likely to be chosen.

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Pledge income tax is an income tax imposing the regular rate of 20% as a deposit guarantee in cases where a loan granted by a company to a related party (parent company, affiliated companies) exceeds the tax exempt threshold. For establishing the tax exempt threshold, the contributions paid into the capital of the lending company and the amounts borrowed by it are summed up. If the loan amount is repaid during a certain period (within 2 years under the current plan), then the remitted pledge income tax is returned and paid to the lender's prepayment account. If the loan is not repaid in the given period, then the pledge income tax is deemed to be a final income tax which cannot be reclaimed from the state.

Financial instruments having similar effect to issuing a loan are intended to be treated in the same way, for example a group account.

After a decision is concluded by the Government, the Ministry of Finance will prepare a draft law for amending the Income Tax Act which will be sent for harmonization. The objective is to enforce the amendments as of 1 January 2018.

Will the daily tax interest rate be 0.03% instead of the effective 0.06%?

Tallinn Administrative Court found in its 5 December 2016 decision that § 117 (1) of the Taxation Act is in conflict with the Constitution for the part that imposes an interest rate higher than 0.03% per day on a taxpayer (10.95% per year) in a situation, where the tax obligation has arisen on the basis of a tax return submitted or amended by the taxpayer itself, ie without any tax

proceedings having been carried out. Now another decision has followed concerning a situation where the tax interest was imposed as an outcome of conducted tax proceedings. Namely, on 13 January 2017 the Tallinn Administrative Court held in administrative case no 3-15-3100 that § 117 (1) of the Taxation Act is in conflict with the Constitution for the part that imposes an interest rate higher than 0.03% per day on late payment of a tax arrear. In relation to the judgments described above, the Constitutional Review Chamber of the Estonian Supreme Court has commenced proceedings and on 26 January joined both cases into one process under number 3-4-1-15-16.

EU Regulation clarifies the concept of an immovable property and connected services

As of 1 January 2017 certain VAT related amendments which were passed on 7 October 2013 with Council Implementing Regulation no 1042/2013 came into effect. This implementing regulation is directly applicable in Estonia and the amendments pertain to the below.

Firstly, it establishes what exactly should be regarded as immovable property in the meaning of the VAT Directive (2006/112/EC). Secondly, the regulation includes a non-exhaustive list of services that are primarily related to immovable property and also which services should be excluded from this category. In other words, a selection is provided reflecting when a service is sufficiently connected to immovable property and when it is not. If such a connection exists, then the service is

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subject to taxation in the Member State where the immovable in question is located. If the immovable is located in Estonia, then the service is taxable in Estonia.

For example, the category of services related to immovable property [art 31 a (2) point h] includes the storage of goods for which a specific part of the property has been assigned for the exclusive use of the customer - if a specific part has not been assigned exclusively to the customer, then the so-called B2B rule applies which gives the Estonian warehouse keeper the right to issue an invoice with 0%, if the customer is a EU taxable business or a non-EU company.

Services that are not deemed to be related to immovable property include for example portfolio management of investments in real estate; provision of a stand location at a fair or exhibition site together with other related services and advertising, even if it involves the use of immovable property for the provision of the advertising service.

To facilitate better understanding of the amendments, the European Commission has published its own comments (*„EU VAT place of supply rules on services connected with immovable property that enter into force in 2017“*¹).

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¹http://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/vat/how_vat_works/explanatory_notes_new_en.pdf