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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Limited partnership (fund)

On 10 January 2017 the new Investment Funds Act which was passed by the Parliament in December 2016 came into effect providing for an entirely new type of fund in the form of a limited partnership. Internationally a limited partnership type of fund is typically used for managing venture capital investments. A number of amendments and additions were simultaneously made to the Income Tax Act to establish the necessary tax treatment of a limited partnership and to ensure its tax transparency.

The possibility of creating a limited partnership

In the Commercial Code, a limited partnership fund is regulated as a fund that is registered in the form of a limited partnership while being subject to special rules deriving from the Investment Funds Act.
A limited partnership has one general partner and one or more limited partners (investors). The form of a limited partnership allows for shaping the relations between partners in a flexible manner with the partnership agreement.

Tax transparency of a limited partnership

Although a limited partnership constitutes a regular legal person for the purposes of civil law, then for tax purposes it is an entirely novel legal formation, which is looked through and receives look-through tax treatment as if it has no legal capacity. A limited partnership is neither a resident nor a non-resident under the Income Tax Act. It is also not considered to be a taxpayer or a payer of fringe benefit tax. A limited partnership is relieved from the obligations of a withholding agent. If a limited partnership earns net profit as a company, then the distribution of dividends or making capital repayments exceeding the amount of payments made into the company are not subject to taxation at the level of the limited partnership.

The investors of a limited partnership are taxed exactly as if they had made the relevant investment into the underlying instrument directly, i.e. not through the fund.

According to the Ministry of Finance, the extraordinary status of a limited partnership for tax purposes should ensure that the source state of income (if the source of income of a limited partnership is outside of Estonia) and the non-resident investor's state of residence look through the limited partnership and apply the tax treaty concluded between themselves directly when allocating the taxing rights of investment income.

Taxation of limited partners

Investment income earned through a limited partnership is taxed at the level of the partners as follows:

1. If a partner of a limited partnership is a resident company, then income tax on the

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share of profit allocated to it will become payable upon distribution of profit or making other payments subject to tax meaning that taxation of the income realized by the limited partnership is deferred (same taxation would apply if the resident company had invested directly).

2. If a partner of a limited partnership is a on non-resident, then only such income that in case of direct investments would be subject to tax in accordance with a respective subsection of ITA § 29 as the non-resident's Estonian sourced income, is taxable proportionally to its participation in the fund. This means that taxation is not based on payments made from the fund, but the realization of income of the fund.

The above mainly pertains to taxable investment income, which the limited partnership has received in relation to immovable property located in Estonia (for example profit from the sale of real estate including indirect real estate income, rental income). If a limited partnership has at least 10% shareholding in an Estonian real estate company meeting certain criteria, then the gain arising from the sale of the shareholding will be taxed at the hands of the owner despite the size of the owner's participation in the fund.

A non-resident partner generally has to declare income received by the limited partnership and attributed to it by 31 March of the year following the year when it was received by the fund. In cases where it includes profit arising from the sale of real estate located in Estonia, then the return must be submitted within one month from receiving the gain [ITA §44 (4)].

3. If the partner of a limited partnership is a resident individual, then income tax is imposed on the income realized by the limited partnership proportionally to his participation in the fund. This of course only applies on the type of income, which is subject to personal income tax (for example, if a limited partnership receives dividends from an Estonian company, then these are not included in the taxable income of a resident individual).

Taxation is based on income realised by the fund and not payments made from the fund. Income tax is calculated separately for each category of income (interest, dividend, rental income or capital gain).

A resident individual must declare income received by the limited partnership and allocated to him by the 31st of March following the year when it was earned by the fund.

Reporting the income of a limited partnership

A limited partnership is obliged to submit a return to the Tax and Customs Board regarding income received in a calendar year and regarding the investors and their respective participations at the time of receiving the income and confirming their residency by 1 February following the calendar year of when the income was received.

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The format of the return will be established with a regulation from the Minister of Finance (not yet available).

If other income and dividends are received through a limited partnership

Income Tax Act § 50 provides for a tax exemption on dividends distributed by a resident company, if these are paid on account of dividends received from a company with at least 10% of shareholding at the time of receiving the dividends (the so-called exemption method). If there is a limited partnership interposed between the payer of dividends and a resident company in which the latter is a shareholder, then the tax exemption is applied to dividends received through the limited partnership, provided that the resident company's participation in the Estonian or foreign distributing company is at least 10% (shares in the distributing company are directly held by the limited partnership).

In order to allow this, a new subsection 1^5 is added to ITA § 50 to equate the taxation of dividends received through a limited partnership with a situation where the resident company invests directly in the underlying company.

If the conditions for applying the exemption method are not met, then the use of the credit method is allowed to avoid double taxation on income received through a limited partnership. The Income Tax Act will be supplemented with a new subsection 5^5 to §54 to achieve this. A resident company can deduct the foreign income tax paid or withheld on the income of the limited partnership proportionally to its participation in the limited partnership from the corporate income tax liability arising at the moment of distributing profits.

The status of a limited partnership in light of other laws

Limited partnership is an accounting entity who is liable to submit an Annual Report to the Commercial Register. The Investment Funds Act does not prescribe any different treatment.

A limited partnership as a legal person is able to register for VAT purposes, if it is engaged in economic activities in the meaning of the Value Added Tax Act, i.e. sells goods or provides services – e.g. acquires real estate and rents it out with the rent being subject to VAT. If the activities of a limited partnership comprise only of holding of shares and receipt/on-payment of dividends, then this does not amount to economic activities.

If a limited partnership has a fund manager, then the provision of fund management services to a limited partnership are considered tax exempt supplies with no right of deduction, since the limited partnership is essentially an investment fund.

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The Tax and Customs Board has updated guidelines on filling out TSD Annex 7

In the end of year 2016, the tax authorities published new guidelines on their webpage providing assistance and explanations on filling out tax return TSD Annex 7. TSD Annex 7 is used for declaring dividends, capital repayments and other circumstances significant in terms of taxation. The guidelines are available in Estonian at: http://www.emta.ee/et/ariklient/tulu-kulu-kaive-kasum/tsd-2016/selgitused-dividendide-omakapitali-valjamaksete-ja-muude

Please see below an overview of the more relevant aspects.

Conversion of a dividend debt into a loan obligation

Based on the decision to distribute dividends, the dividend and income tax liabilities should be reflected in the balance sheet on accrual basis. Income tax must be remitted in the period when the dividends are actually paid.

A payment does not only refer to a bank transfer or a cash payment, but for example it could also mean a mutual settlement of claims. A company and its shareholder may agree that the dividend debt created by the decision to pay dividends will be converted into a loan obligation either partly or fully so that no actual payments are made. Despite the fact that no payments are made in such instances, the tax authorities find that the conversion of the dividend debt into a loan obligation is equivalent to a dividend payment and thus income tax liability arises by the 10th day of the month following the conversion.

Voluntary reserve

The Income Tax Act does not define what is considered to be a payment made into capital/equity. The tax authorities' guidelines clarify that payments made into the voluntary reserve in accordance with the Commercial Code are inter alia accepted as paid-in capital of a company, but this would entail an amendment to the Articles of Association of a company. Shareholders are able to make both monetary and non-monetary contributions (e.g. conversion of a previously issued loan into the reserve) and as a rule such a reserve is formed with the aim of restoring net assets.

In conclusion, contributions into the voluntary reserve are declared in line 7030 only if forming the reserve has been in line with the requirements set forth by the Commercial Code. If any payments are later made from this voluntary reserve, then this is considered a capital repayment for taxation purposes.

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Transferring rights relevant for taxation upon mergers/ demergers

When a company undertakes a merger or a demerger, then the merging/demerging company can transfer to the surviving/recipient company (i.e. from tax return to tax return) the following rights related to taxation: unused paid-in capital; foreign withholding tax on foreign income, which has not yet been used to reduce the income tax liability; income received that can be on-distributed tax exempt.

According to the guidelines of the tax authorities, the merging/demerging company must submit TSD Annex 7 part III before the respective insertion in the commercial register is made, and the surviving/recipient company should submit TSD Annex 7 part IV after the respective entry is made in the commercial register. In practice it has nevertheless been possible for the deleted merging company to submit TSD Annex 7 part III via the e-tax authorities immediately after the entry is made or alternatively by the 10th date following the month of making the respective entry.

Eliminations in the course of a merger

The tax authorities have taken the position that the eliminations of paid-in capitals in the course of a merger should be performed under the Income Tax Act (ITA) § 50 (2) regardless of the direction of the merger (ordinary or so-called reverse merger) meaning that the outcome should be the same in both instances. The surviving company cannot include contributions that it has itself made into the merging company and the merging company cannot take into account paid in capital that has been contributed into its equity by the surviving company.

The tax authorities accept a situation where for example the parent company acquires a subsidiary and if subsequently a merger is effected, then it is possible for the subsidiary to transfer its remaining paid-in capital to the parent company, since the parent company has not itself made payments into equity (because these have been made by a third person).

Amendments to the payment and declaration of dividends as of 1 November 2016

On 1 November, the amendments to ITA (§50 (1^3 and 1^4) came into force, which in conjunction with two additional conditions limit the use of the exemption method, whereas the restriction will apply to dividend distributions and capital repayments received after 1 November 2016.
The tax authorities have published the following guidelines on September 30 explaining the amendments available in Estonian at: http://www.emta.ee/et/ariklient/tulu-kulu-kaive-kasum/muudatused/muudatused-dividendide-maksmisel-ja-deklareerimisel

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Going forward, the exemption method can only be applied if the dividends received from the foreign subsidiary have been classified as dividends in the other state as well (as opposed to interest cost reducing the taxable income).

In addition, a more general limitation came into force which can be seen as a specification to §84 of the Taxation Act and which can be summed up by stating that if the main purpose or one of the main purposes of establishing or acquiring a company in a foreign country, was to obtain a tax advantage, then it is not possible to on-distribute such received dividends tax exempt. If the taxpayer is certain that the exemption method applies to dividends and capital repayments received after 1 November 2016, then this is to be confirmed by reporting the said income on part II of TSD Annex 7 of the month of receipt of such income.

In the case of foreign holding companies we suggest analyzing (or recalling) to which purpose the respective holding company was established for and whether it has sufficient economic substance for carrying out its functions.