

*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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# Tax alert

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### Tax Alert May 2017

#### I. „Pledge income tax“, 14% and 7% income tax rate on dividends and implementing provisions

The Ministry of Finance has recently completed the draft law for amending the Income Tax Act, which was sent for rounds of approval on 17 April 2017 and is available via the draft law directory (reference number RAM/17-0473).

The draft law provides for two measures to be implemented into the Income Tax Act that should become effective as of 1 January 2018. In order to allow the changes to come into effect on 1 January 2018, these must be passed on 30 June the latest, meaning that the draft law is of urgent nature.

##### „Pledge income tax“

The Ministry of Finance is planning to implement a corporate income tax charge on certain intra-group loans, since in the legislator's view these in essence often constitute either a hidden profit distribution to the parent company or a non-business related payment. The legislator argues that reclassification of such loans under the General Anti Avoidance Provision (so-called GAAR) of the Taxation Act in the course of audit proceedings takes up significant resources of the Tax and Customs Board and can still prove very complex especially in situations where an arm's length interest is accrued on the

loan. Therefore, it is supposedly an appropriate measure to introduce a special provision.

To achieve this, Income Tax Act §52 listing the types of payments which are considered not to be business related and providing for their tax treatment, will be complemented with a new subsection. A payment made upon issuing a loan is taxed with income tax, if as of the last day of a calendar month the tax exempt threshold is exceeded. The threshold ensures that only the part of the loan which is issued on account of net profits is taxed. The threshold will be the combined amount of payments made into the capital of the company that have not been paid out and the sum of loans taken. The tax liability arises if payment is made:

1. „upward“
  - Either from a subsidiary directly to a parent company; or
  - Another company equivalent to a parent company placed above the lending entity in the group structure, e.g. to a shareholder of the parent company;
2. „sideways“
  - From one subsidiary to another subsidiary of the same parent company.

##### Conditional income tax liability

The above described tax liability is not final since there will be a possibility to partly or fully reclaim the paid income tax, if the loan is fully or partly repaid during two years as of the last day of the calendar month of when it was issued. This is

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why the media has titled the described income tax liability as the “pledge income tax”. Until now a similar pledge income tax has applied to loans issued to companies resident in low tax territories, but in those cases refunding the income tax is granted without a time constraint.

It will become mandatory to disclose information regarding loans taken in a TSD annex (most likely Annex 6).

### *Definition of a loan*

The definition of the term “loan” will become increasingly important. In addition to loans granted under regular loan agreements, taxation will cover providing a guarantee for a loan taken by the parent company, credit line agreements and other “economically equivalent transactions” to avoid sidestepping the tax by using financial instruments with economically similar effect. As an exception, lending funds through a group treasury account is excluded from the scope if it is short-term and (up to a period of one year) with the goal of managing the liquidity of the group.

### *Implementing provisions for “old” loans and reporting*

It is essential to pay attention to the implementing provisions to ensure that the income tax liability does not occur unexpectedly.

Although it is planned to enforce the law only as

of 1 January 2018, then the actual tax effect of the amendment may also concern certain loans granted prior to that date, **if such a loan was issued after 1 July 2017 and it has not been repaid to the lender by 31 December 2017.** Such loans must be declared in the respective annex of TSD January 2018 (most likely annex 6) by February 10. 2018 – based on the implementing provision these will be equated with loans issued in January 2018 and subject to taxation with the submission of January 2018 TSD on 10 February 2018.

Furthermore, if a qualifying loan’s payment terms are extended or the loan amount is increased after 1 July 2017, then this will also be deemed granting a loan subject to pledge income tax.

## *II. 14% income tax rate on regularly distributed profit*

The objective of the second initiative regarding income tax is to reward companies with a more stable dividend policy with a lower income tax rate. The payment of dividends in the amount which is below or equal to the extent of taxed dividends paid during the three preceding years (20%), will be taxed with a rate of 14% (the tax rate on the net amount being 14/86 instead of the regular 20/80).

The actual effect of this measure will be visible in 2019 at the earliest, on the presumption that in 2018 dividends subject to 20% were distributed. Year 2018 will be the first year taken into account for the calculation of the average taxed distributed

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profit of three years.

For example if in year 2018 dividends are distributed in the amount of 120,000 EUR on account of profits earned in previous periods and income tax of 30,000 EUR was paid to the state, then in 2019 it would be possible to distribute 1/3 of the 2018 profits with a tax rate of 14% (i.e.  $40,000 \times 14/86$ ). The remaining distribution would be subject to the 20% tax rate.

### 7% income tax rate

In fear of an increase in payment of “dividend salaries”, the total corporate income tax burden of a dividend is kept at approximately 20%, if the recipient of a 14% dividend is either a resident or non-resident individual. To this purpose, a 7% withholding tax rate will apply, unless a tax treaty provides for a lower rate of withholding tax (5% or 0%).

If a non-resident legal person is the recipient of the dividends, then withholding tax does not apply.

### III. Advance income tax for banks

The Ministry of Finance has unexpectedly drafted and promptly sent for rounds of approval another draft law for amending the Income Tax Act, which can be viewed via the draft law directory (reference number RAM/17-0514).

The draft law proposes changes to the Income Tax Act coming into effect on 1 January 2018 in order to tax the profits of banks (instead of the so-called bank levy, which was initially included in the coalition agreement). For the amendments to become effective as of 1 January 2018, these must be passed prior to 30 June 2017.

The draft law provides for taxation of net profits earned by banks with income tax before distributing dividends. Due to this, new provisions are included in the Income Tax Act according to which Estonian banks, including branches, should remit income tax by the 10th day of the third month of each quarter as an advance 14% payment on their “own” profits earned in the previous quarter. The amendment is hoped to ensure a more regular income tax flow into the state budget, since generally banks have adhered to very conservative dividend policies, which have not coincided with the state’s fiscal interests.

The current profit which is the basis for paying income tax is determined according to the interim accounting report for the 3, 6, 9 and 12 month of the financial year. For example the payment for the first quarter must be remitted by March 10 the latest and it will be based on the report on IV quarter of the financial year, as it must be published within two months after the end of the reporting period. **Pursuant to the transitory provision, the first payment is due only on 10 September 2018 and the calculation will be based on the interim report on 2018 second quarter.**

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Banks will be submitting a new TSD return annex for reporting their tax obligation (TSD annex 8).

It is hoped that the state budget will receive 27 MEUR from this measure in 2018.

Since this constitutes an advance income tax, then it will be possible to deduct the advance payments made in previous calendar years from the future tax obligation arising from the payment of dividends or making other payments from the share capital.

The amendments will be explained in more detail in the next Tax Alert.

## ***IV. Draft law for amending the Value Added Tax Act and Income Tax Act***

The Ministry of Finance has just finalized and sent for rounds of approval the draft law for amending the Value Added Tax Act and Income Tax Act which is available in the draft law directory (reference no RAM 17-0510).

According to the draft law, the redactions of the VAT Act and Income Tax Act coming into force on 1 January 2018 will be supplemented with rules on determining the price of the fringe benefit of vehicles in “so-called” mixed use (going forward the basis for the tax base will be kilowatt) and additionally the VAT Act rules regarding self-supply will be unified with the rules underlying the taxation of fringe benefits. In order for the changes to come into force on January 2018, these must be passed by 30 June 2017, making the draft law of urgent nature.

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