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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Update on the pledge income tax

In the tax alert of May 2017 we explained the principles of the pledge income tax contemplated by the Ministry of Finance, which in essence meant that a corporate income tax charge was to be imposed on certain intra-group loans, which were deemed to be either a hidden profit distribution to a parent company or a non-business related expense.

However, the Government recently decided against implementing the pledge income tax in the initially planned format.

Please see below for more detailed explanations how the Ministry of Finance plans to replace the initial pledge income tax and what would be the relevant consequences.

New anti-abuse clause

The initial pledge income tax will be replaced by a new anti-tax avoidance clause (ITA § 50²), which obliges a resident company to pay income tax on a loan issued to a shareholder or a partner, if the "circumstances of the transaction indicate that it might be a hidden profit distribution". According to the Ministry of Finance, a loan is considered to be a hidden profit distribution, if there is no intention of repayment or the ability to repay the loan cannot be proven. The Ministry of Finance considers this provision to be a specification rather than an amendment to the Income Tax Act, meaning that there will not be an "amnesty" of any kind and theoretically all historical loans resembling a profit distribution could be in the scope of application of this clause.

In order to implement the provision, the Tax and Customs Board is to publish respective guidelines.

Reverse burden of proof

If the due date of an outbound loan exceeds 48 months, then the Ministry of Finance assumes that certain loans issued to related parties may constitute hidden profit distributions and once the deadline is met, the burden to prove the opposite lies with the taxpayer. The reverse burden of proof applies to:

1. a loan issued to the parent company of the lender (in the meaning of §6 of the Commercial Code);
2. a loan issued to the parent company of the lender (in the special meaning of the Income Tax Act);
3. a loan issued by the lender to another subsidiary of the parent company.

Obligation to declare

Income Tax Act § 56 (1) is amended to introduce an additional reporting obligation regarding intra-group loans. Going forward, all resident companies

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must report loans issued to parent and so-called sister companies in the meaning of Income Tax Act § 50[2] as well as the repayment of such loans.

Implementing provision for „old loans“

Although replacing provision of the pledge income tax is planned to be enforced starting from 1 January 2018, then under the implementing provision, the reporting obligation and the reverse burden of proof will already apply to loans issued as of 1 July 2017, also regarding loans which undergo an increase in the loan amount, extension of repayment terms or other changes in material terms after 1 July 2017.

Avoidance of double taxation

The Ministry of Finance has taken into account the criticism on the time constraints on the repayment of a loan subject to the pledge income tax, which could have resulted in double taxation. Since the pledge income tax is to be replaced with taxation of the issued loan in instances where the circumstances suggest that it might be a hidden profit distribution, then double taxation is avoided by an exception under which a dividend exemption is allowed if dividends are paid out on account of such taxed loan that has been returned to the taxpayer.

There are no time limitations/constraints on repayment of the loan.

14% corporate income tax rate on regularly distributed profit

The Ministry of Finance did not change the principles of the draft law (SE 458 I) regarding the provisions [ITA § 50[1] and 61 (51)] on the 14% income tax rate on regularly distributed profit (please refer to Tax Alert of May 2017, section II).

The year 2018 continues to be the first calendar year which will be taken into account for the calculation of the average taxable distributed profit of the three preceding years. Hidden profit distributions may not be taken into account for determining the taxable base.

Simplified taxation of business income

The Parliament has a separate draft law under discussion which is likely to be called the Simplified Business Taxation Act (454 SE I). This constitutes an entirely new tax in the meaning of the Taxation Act. The law is planned to come into force on 1 January 2018.

According to the draft law, a resident or non-resident individual will have the possibility to open a specific account in a bank (so called “entrepreneurship account”), where all service fees or income from sale of goods that are transferred to it will be taxed at a flat rate of 20%, if the total amount is below EUR 25,000 in a calendar year.

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If the total amount exceeds EUR 25,000 in a calendar year, then the tax rate applicable to the excess amount is 40%. Service fees are considered to be remuneration for services performed under agreements for provision of services in the meaning of the Law of Obligations Act. According to the Ministry of Finance, such form of entrepreneurship should be best suited for a person occasionally engaged in "micro business activities" and **who is not active in the same field as a sole proprietor**, **but is** not willing to spend time on accounting nor incurs substantial expenses on means of work, because expenses cannot be deducted.

The tax due is transferred to the tax administrator by the bank and it is to cover income tax, social tax and mandatory pension fund contributions. If the paid amount exceeds the obligatory minimum social tax liability, then the person will become entitled to health insurance coverage. The precondition for health insurance is receiving at least EUR 1,300 per month to the entrepreneurship account (calculated based on the minimum social tax liability that will be in force from 2018).

Measures to prevent employers abusing the entrepreneurship account

The draft law includes special provisions to prevent employers from pressuring employees and persons engaged under service agreements to open entrepreneurship accounts to save costs on payroll taxes. To this aim, a payment for a service made to an individual will under this special regime will be deemed as a non-business related payment triggering income tax of 20/80 for a resident company. The same principle applies to a sole proprietor and a non-resident legal person's permanent establishment. These special provisions do not apply on sale of goods.

Special provisions are designed to make the acquisition of services from an individual with an entrepreneurship account unattractive for a company. It can be expected that in essence the entrepreneurship account will become a general rule for occasional work performed („hack-work"), for example if a private person needs plumber, a tutor, a babysitter or domestic help etc. It is questionable, whether cash payments usually paid for incidental work/services (*de facto* non-taxable) will so easily be replaced with payments made to entrepreneurship accounts and 20% taxation, since somebody is bound to bear the cost and the customer is normally not keen to do so.