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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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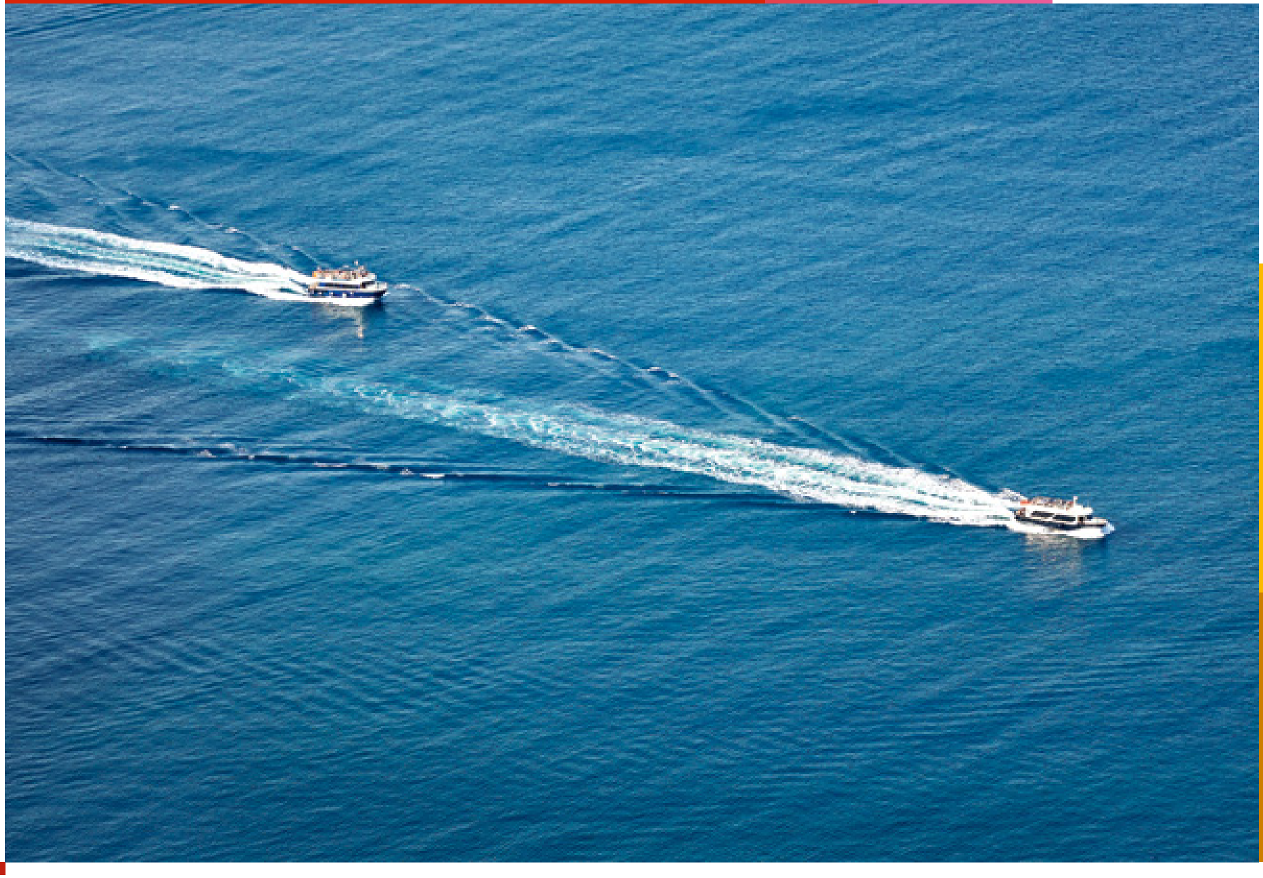

Legal acts ATAD

The Ministry of Finance has submitted for rounds of approval a new draft law amending Income Tax Act with the principal aim to transpose the anti tax-avoidance rules from the EU 2016/1164 Anti-Tax Avoidance Directive or the so-called ATAD into Estonian legislation. The ATAD was already briefly discussed in our July 2016 Newsletter. ATAD is based on OECD rules, which were taken as the basis for providing the minimum standards of anti tax-avoidance measures to be applied within the EU.

The draft law foresees that the amendments should be adopted by 1 January 2019 as this is the deadline posed on Member States for adopting the Directive. The Ministry of Finance is not expecting a significant increase of the income tax to the state budget as a result of the amendments.

New chapter

Income Tax Act (ITA) will be supplemented with a new chapter (10^1), which will include most of the new measures transposed from the Directive against profit shifting and tax base erosion. Five new paragraphs will be included in the new chapter: § 54^1 - § 54^5.

Abuse of profit taxation rules will trigger taxation

General anti avoidance rule (§ 5^1) will be introduced with the main aim of ignoring any transaction or chain of transactions which have been conducted with the main purpose of gaining a tax advantage for the purposes of income taxation.

As a result of introducing the new general anti avoidance rule (often referred to as the GAAR) the previous similar provision of ITA § (50 (1^4)), which was in force from 1.11.2016 to prohibit the abuse of the exemption method on dividend distributions will be annulled. The new GAAR will be applicable within the whole ITA and therefore should also cover this specific situation.

Income, which the Estonian resident company (or Estonian permanent establishment) did not receive or expense, which was borne in connection with the aforementioned transaction or chain of transactions will be subject to income tax pursuant to the new provision (**ITA §-s 54^1**).

Income tax on the undistributed profits of Controlled Foreign Companies (CFC rules)

Until now the Estonian CFC rules have only been applicable on transactions conducted by private individuals (ITA § 22). The rules foresee for attribution and taxation of profits of offshore companies controlled by Estonian private individuals as if these were distributed to the private individuals.

These provisions will remain in force and in addition a new tax object will be included. Namely, taxation of profits of a controlled foreign company at the level of Estonian resident company (or a permanent establishment) if the criteria laid out in **ITA § 54^4** for attribution of profits is met. Unlike the general rule for declaring tax, such profit must be declared by the taxpayer based on the financial year of the controlled foreign company. For example if the financial year matches the calendar year, the profit should be declared by 10 July and tax remitted by 10 September.

Controlled foreign company is defined as any non-resident enterprise in which the resident company alone or together with related parties holds more than 50% of shares, profits or voting rights. Estonia has opted to transpose the rule so that the tax rate of the foreign jurisdiction is irrelevant. As a result any company located in any EU Member State (e.g. Cyprus, Malta or the Netherlands) or company located outside the EU could fall within the scope of the CFC rules.

In order for the tax obligation to be triggered the following conditions must be met:

1) the underlying transaction or chain of transactions of the controlled foreign company which created the profit was fictitious;

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2) the principal aim of the underlying transaction or chain of transactions was gaining a tax advantage;

3) the factual management of the CFC is undertaken by key employees of the shareholder (the controlling company) and this created the opportunity to derive the profit.

In practice deciding whether the abovementioned conditions are met or not will be the most complicated part about the application of the provision.

Therefore, going forward the establishment of foreign companies or even the use of existing foreign companies should be carefully considered and determined whether sufficient business reasons exist in light of the new tax rules.

Exceeding borrowing costs

Deduction of excessive borrowing costs (as a general rule interest expenses) from tax base will be limited if the following three criteria are met and none of the exceptions apply (**§ 54²**). The provision will not apply to financial undertakings (banks, insurance companies) and standalone entities. Standalone entity is a taxpayer, which is not part of a consolidated group and has no associated companies or permanent establishment(s).

The criteria is as follows.

First, it needs to be established whether the borrowing costs in a financial year exceed 3 MEUR. If not, then the fulfillment of the next criteria does not need to be checked. If yes, then it needs to be established if the borrowing costs exceed 30% EBITDA-d (i.e. earnings before interest, taxes, deductions). If yes, it needs to be established whether the company is in a profit or loss-making position to determine whether the borrowing costs which exceed 3 MEUR and 30% EBITDA, exceed losses. If yes, income tax must be paid on the part exceeding the loss.

As an exception to the general rule of declaring and paying tax on a monthly basis, such taxation will follow the financial year. Exceeding borrowing costs must be declared by 10 July and tax paid by 10 September if the financial year matches the calendar year.

The threshold, which triggers taxation is very high in the context of Estonia and since there are also exceptions to the general rule, the Ministry of Finance estimates that there would be approximately 10 companies in Estonia which are potentially impacted by this rule.

Exit taxation

The idea behind exit tax (**ITA § 54³**) is to guarantee that when a resident company transfers assets from Estonia to its permanent establishment(s) in other state(s) then income tax is charged on the amount which equals to the fair market value of the transferred asset (the company will have the right to deduct capital contributions from the tax base). If a resident company transfers its tax residency away from Estonia then taxation will be triggered according to ITA § 50 (2)² meaning the tax base will be capital repayments exceeding capital contributions.

In case of transfer of tax residency or assets within EEA member states the payment of exit tax can be deferred by paying it in instalments over 5 years.

Broadening the applicability of exemption method

ITA § 50 (1)¹ will be supplemented with new subsections to broaden the scope of application of exemption method on dividend distribution. Exemption will also be granted on dividends paid on account of assets upon the transfer of which exit tax has been paid or dividends received from controlled foreign companies or from sale of shares in such companies to the extent of the taxed amount.