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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Legal acts

ATAD is complete

The Government has approved the draft law amending the Income Tax Act for transposing anti tax-avoidance rules from the EU Anti-Tax Avoidance Directive 2016/1164 ("ATAD") into Estonian legislation. As a next step, the draft law will be discussed by parliament.

The directive was briefly discussed in our July 2016 and May 2018 Tax Alerts.

ATAD itself is based on OECD rules which were taken as basis for designing the minimum standards of anti tax avoidance measures to be introduced within the EU.

Adopting the Directive

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

New chapter in ITA

Income Tax Act (ITA) will be supplemented with a new chapter (101) which will include most of the new measures transposed from the directive to fight against profit shifting and tax base erosion. Five new sections will be included in the new chapter: § 54^{1} - § 54^{5}.

Abuse of advantageous tax rules will trigger taxation

A general anti avoidance rule (§ 5^{1}) will be introduced with the main aim of disregarding any transaction or chain of transactions having been concluded with the main purpose of gaining an income tax advantage which defeats the objective of the applicable tax provision or tax treaty. If a special anti avoidance rule exists, then the special provision is applied.

The tax advantages can be categorized as permissible and non-permissible. If, having regard to all relevant facts and circumstances, the transaction would have been carried out in the same legal form even if no tax advantage was obtained with the transaction, then the receipt of the tax advantage is deemed to be permissible. That means that the receipt of a tax advantage should be treated as an additional bonus, rather than a reason for the transaction.

As a result of introducing the new general anti avoidance rule (GAAR), a similar provision of ITA [§ 50 (1^{4})] effective since 1 November 2016 and prohibiting the abuse of the exemption method on dividend distributions, will be deleted. The new GAAR will apply to the entire ITA and therefore should also capture this specific situation.

Any income which an Estonian resident company or an Estonian permanent establishment is deprived of or an additional expense it bears as a result of the aforementioned transaction (or chain of transactions) will be subject to income tax at the rate of 20/80 pursuant to **ITA § 54^{1}.**

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

Until now the Estonian CFC rules have only applied to private individuals (ITA § 22). The rules foresee attribution and taxation of profits of *off-shore* companies controlled by Estonian resident individuals.

These provisions will remain in force, but an additional tax object will be included. Namely, profits of a controlled foreign company will be taxed in the hands of an Estonian resident company (or a permanent establishment) if the criteria laid out in **ITA § 54^{4}** for attribution of profits are met.

As opposed to general rules for declaring tax, such profits are to be declared by the taxpayer based on the financial year of the controlled foreign company. For example, if the financial year coincides a calendar year, then the profit

should be declared by 10 September and tax remitted by 10 September.

Controlled foreign company (CFC)

A controlled foreign company is defined as any non-resident enterprise in which the resident company alone or together with its related parties holds more than 50% of the voting rights or capital, or is entitled to receive more than 50% of the profits. Estonia has opted to transpose a version of the rule under which the tax rate of the foreign jurisdiction is irrelevant. This means that a company located in any other EU Member State (e.g. Cyprus, Malta or the Netherlands) or a company located outside the EU could fall within the scope of CFC rules. Thus, Estonia's approach is based solely on whether the income of a foreign controlled company has been derived from fictitious transactions with the main purpose of obtaining a tax advantage.

A foreign permanent establishment of an Estonian company is also considered to be a controlled foreign company.

When are the conditions for attribution of profits met?

In order for the tax obligation to be triggered the following conditions will have to be me:

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

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

3) the CFC is effectively managed by key employees of the shareholder of the controlling company which created the opportunity to make a profit.

It can be expected that in practice determining whether the abovementioned conditions are met or not will become the most complicated part about the provision. Therefore, going forward the establishment of foreign subsidiaries or even the use of existing subsidiaries should be carefully weighed to conclude whether sufficient business reasons exist in light of the new tax rules.

Applying the exception

Compared to the original version of the draft, it is important to note that it has been decided to transpose the exception allowing the company to exclude from the scope of the provision a foreign controlled company which simultaneously meets the following two conditions:

1) the accounting profit of the previous financial year did not exceed EUR 750,000;

2) other revenues of the foreign company, such as profits from subsidiaries, affiliates and financial investments, interest income and other financial income (i.e. non-trading income) did not exceed EUR 75,000 during the same period.

Exceeding borrowing costs may be subject to income tax

Exceeding borrowing costs (§ 542) will be taxed, if they exceed set thresholds. The tax base can be reduced by losses.

Generally, borrowing costs are interest expenses on all types of obligations, but also other costs that accompany borrowing (e.g. guarantee and arrangement fees). The concepts of both borrowing costs and exceeding borrowing costs will be provided in ITA.

The provision will not apply to financial undertakings (banks, investment companies, insurance undertakings) and standalone entities.

Legal acts

How to determine if the exceeding borrowing cost should be taxed?

Firstly, the amount of exceeding borrowing cost should be determined. This is basically the net interest, i.e. the amount of interest expense (or borrowing costs) that exceeds interest income. If the earned interest income is zero, then the amount of net interest equals the interest expense.

Secondly it should be established whether the borrowing costs exceed the threshold of EUR 3 million. If not, then no tax obligation arises.

If the threshold of EUR 3 million is however exceeded, then it should be established whether the borrowing costs are above the 30% EBITDA (i.e. earnings before interest, tax, depreciation, amortization). If not, then no income tax obligation should be triggered. If the borrowing costs are above the 30% EBITDA, then the next step is identifying whether the company is in a profit or loss-making position, because losses can be used to reduce the taxable base.

For example, if a company's EBITDA was EUR 20 million, from which 30% is EUR 6 million (20*0,3=6 i.e. the permissible threshold) and the net interest was EUR 10 million, then the net interest exceeds the threshold by EUR 4 million. If the company made a loss of EUR 5 million, then no income tax obligation should be triggered because the company's loss was greater than the amount exceeding the threshold (4-5=-1). Alternatively, if the company's loss had been EUR 2 million, then the tax object would also be EUR 2 million as the loss was less than the amount exceeding the threshold (4-2=2).

As an exception to the general rule of declaring and paying tax on a monthly basis, taxation of these costs will take place once in a financial year. Exceeding borrowing costs must be declared by 10 September and tax paid by 10 September if the financial year coincides with the calendar year.

Since the threshold for exceeding borrowing costs is high considering the Estonian market and there are a number of exceptions to the provision, then the Ministry of Finance expects very few companies to be affected by this limitation.

Exit taxation

The purpose of the exit tax (ITA § 54^3) is to ensure 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 (positive) difference between the fair market value of the transferred asset and the book value at the time of the asset transfer. A number of exceptions are also implemented.

If a resident company is deleted from the register either as a result of liquidation proceedings or not (e.g. by way of demerger or merger), then taxation is triggered according to ITA § 50 (2^2), where the tax base will be the amount of liquidation proceeds or part of the fair market value of the asset which exceeds the balance of paid-in capital. Domestic mergers will continue to be tax neutral.

In case of transfer of tax residency or assets to an EEA member state (except Lichtenstein), the payment of exit tax can be deferred by paying it in instalments.

Broadening the applicability of exemption method

ITA § 50 (1^1) will be supplemented with new sub-provisions (p 8 and 9) to broaden the scope of application of exemption method on dividend distributions. Exemption will also be granted to dividends paid on account of assets upon the transfer of which exit tax was paid or dividends received from controlled foreign companies or from sale of shares in such companies to the extent of the amount that was taxed.

Interesting development

The obligation to submit nil TSD returns will be abolished. Currently form TSD has to be submitted by VAT registered

persons even when there is nothing to declare. To reduce the administrative burden, such returns will no longer be required.

Permanent establishments must declare balance of tax assets

Non-resident legal persons with a permanent establishment in Estonia must declare [§ 61 (60)] by 10 February 2019 on form TSD the balance of assets taken into and taken out of Estonia as of 31 December 2018. Once the draft law is passed, the assets taken into and out of Estonia are to be declared on an ongoing basis according to transactions that have taken place in a respective month.

If the balance is not declared as of 31 December 2018, there may be an obligation to pay income tax on profit attributed to permanent establishment, because all of the assets that are taken out of Estonia after 01 January 2019 are taxed with income tax according to their fair market value. Complying with the submitting the declaration can therefore reduce the future tax base.

A similar obligation had to be filled by resident companies by 10 February 2015 regarding the balance of paid-in capital as of 31 December 2014 which had to be declared by 10 February 2015.