Estonian tax news (3/44/18)

This article provides an update on changes to Estonian tax laws.

Amendments to the Income Tax Act

The Estonian government has approved amendments to the Income Tax Act transposing the anti-tax avoidance rules of Council Directive (EU) 2016/1164 into Estonian legislation. The Income Tax Act will have a new chapter including most of the new measures transposed from the directive to combat tax base erosion and profit shifting.

Abusing advantageous tax rules will trigger taxation

A general anti-avoidance rule will be introduced to ignore any transaction or chain of transactions concluded with the main purpose of gaining an income tax advantage that defeats the object of the applicable tax provision or treaty. If a special anti-avoidance rule exists, the special provision will be applied.

Tax advantages can be split into permissible and non-permissible. If, based on all relevant facts and circumstances, a transaction would have been carried out in the same legal form without obtaining a tax advantage, the advantage will be recognised as permissible. In other words, a tax advantage should be treated as a bonus rather than a reason for the transaction.

Income tax on undistributed profits of controlled foreign companies (CFCs)

Estonia’s CFC[1] rules have so far been applicable to private individuals, as they provide for attributing and taxing profits of an offshore company controlled by an Estonian-resident individual. In future, a CFC’s profits will be taxed in the hands of an Estonian-resident company or a permanent establishment (PE) if the criteria for profit attribution are met. The taxpayer is to report such profits based on the CFC’s financial year.

Criteria for profit attribution

For a tax liability to be triggered, the following conditions will have to be met:

1. The transaction or chain of transactions generating the CFC’s profit was fictitious;
2. The main goal of the transaction or chain of transactions was to obtain 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.

In practice, determining whether these conditions are met is likely to become the most complicated part of applying this rule. This means that incorporating a new foreign subsidiary or even using an existing subsidiary should be carefully considered to find sufficient business reasons in the light of the new rules.

Applying the exception

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

1. the accounting profit for the previous financial year did not exceed EUR 750,000; and
2. other revenues, 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.

Exit taxation

The purpose of exit tax is to ensure that when a resident company transfers assets from Estonia to its foreign PE, income tax becomes chargeable on the amount equal to the (positive) difference between an asset's fair market value and net book value at the time of the transfer, subject to a number of exceptions. Domestic mergers will continue tax neutral. On the transfer of tax residency or assets to an EEA member state (except Liechtenstein), exit tax can be deferred and paid by instalments.

[1] The CFC is defined as a non-resident enterprise in which the resident company alone, or together with its related parties, holds more than 50% of voting rights or capital or is entitled to more than 50% of profits. Estonia has opted to transpose a version of the rule under which the foreign jurisdiction's tax rate is irrelevant, i.e. a company located in any other member state (e.g. Cyprus, Malta or Netherlands) or outside the EU could fall within the scope of CFC rules. Estonia's approach is based solely on whether a CFC's income derives from fictitious transactions with the main purpose of obtaining a tax advantage. An Estonian company's foreign PE is also considered a CFC.