



## **Lex Mundi European Union: Accession States Tax Guide**

### **ESTONIA Lepik & Luhaaar**

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#### **A. General information**

Due to its successful structural reforms and open economy, Estonian business and investment climate has developed greatly over the last decade. According to the statistics published by the Ministry of Economic Affairs and Communications, Estonian Economic Growth accelerated in 2005 to 9,5 %, surpassing the mean economic growth of the past five years by 2,6 percentage points. The Ministry has also predicted 7,3%-7,7% GDP real growth for 2007-2010.

Estonia has adopted relatively low tax rates, which has promoted the foreign investment and domestic development. According to the 2007.a. state budget, the state's profits from the taxes levied in aggregate will approximately be 60 170 millions EEK, with the indirect taxes (excises, VAT and gambling tax) amounting to approximately 28 291 million EEK (i.e. approx. 47%) and the direct taxes covering the rest.

#### **B. Corporate income taxation**

##### **1. Which are the taxable entities?**

Resident legal persons are subject to income tax on worldwide income. Resident legal persons include (i) private legal persons and (ii) public legal persons. Private legal persons are legal persons founded in private interests and pursuant to a legal act concerning the corresponding type of legal persons. The state, local governments and other legal persons founded in the public interest and pursuant to a legal act concerning such legal person are public legal persons.

Non-resident legal persons not having a permanent establishment (“PE”) in Estonia are subject to income tax on particular categories of income listed in the Estonian Income Tax Act, as further limited by the applicable tax treaties. Income of non-resident associations of persons or pools of assets without the status of a legal person (i.e. trusts) is subject to taxation as the income of the shareholders or members of such association or pool in proportion to the sizes of their holdings.

## **2. How is the taxable income determined?**

Estonia has adopted a unique corporate income tax system where only distributed profits are subject to income tax, with the retained earnings being fully exempt. Taxable distributions include dividends, fringe benefits, gifts and donations, and expenses not related to business. Since only distributed profits are subject to tax, there are only very few deductions available: in particular, if the dividends received from a subsidiary company are paid out further again as dividends, then if the share of the profit distributing entity in the subsidiary company is at least 15%, then no additional tax has to be paid.

PEs of non-resident entities are subject to income tax based on similar rules: assets transferred out of the PE are considered taxable distributions and taxed at the same rates as distributions made by resident companies.

## **3. What are the applicable tax rates?**

As of 01.01.2007, profit distributions described above are subject to income tax at 22/78 of the net amount of the distribution (i.e. 22% of the gross amount). As the law currently stands, the tax rate shall decrease gradually over the coming years (21/79 as of 01.01.2008 and 20/80 as of 01.01.2009).

Please note that the above-described Estonian tax system is considered by the European Commission to be in conflict with the Parent-Subsidiary Directive and therefore Estonia has been granted a transitional period with respect to its current tax system until end 2008. At the moment, although a public discussion is in progress, there is no reliable information with regard to the changes to be introduced in 2009.

## **4. Are capital gains taxed separately?**

No. Capital gains received by resident legal persons are not subject to taxation until they are distributed, e.g. as dividends (see above for details regarding dividend taxation).

## **5. May losses be carried back or forward and to what extent?**

Since only distributed profits and other distributions are taxed, losses cannot be carried back or forward.

## **6. Are there any withholding taxes and at which rates?**

Payments between resident legal persons are not subject to withholding. Various payments made by resident legal persons to non-residents are subject to withholding, including dividends payable to non-resident shareholders holding less than 15% and off-shore entities; interest paid in excess of arm’s length interest, certain royalties, etc. Rate of withholding tax is generally 22%. License

fees, payments to artists and sportsmen and payments for services performed by a non-resident in Estonia are subject to withholding at 15%.

Applicable tax treaties typically reduce the withholding rate with regard to dividends down to 15%, with regard to interest down to 10% and with regard to royalties down to 5/10%.

#### **7. Are there any preferential group taxation rules in force?**

No. Please note, however, that if a resident company pays out as dividends on the account of dividend income received from a subsidiary company, then if the holding of the distributing entity in the subsidiary is at least 15%, then corporate income tax is not payable.

#### **8. Which are the anti-avoidance rules currently in force?**

According to the general “substance-over-form” clause, if it is evident from the content of a transaction that the transaction is performed for the purposes of tax evasion, conditions which correspond to the actual economic content of the transaction apply upon taxation.

Transfer pricing rules apply to all transactions entered by resident legal persons, PEs of non-resident legal persons as well as resident sole entrepreneurs with an associated party.

According to Estonian CFC rules, income tax is charged on the income of a legal person located in a low tax rate territory and controlled by Estonian residents, irrespective of whether the legal person has distributed any profits to taxpayers or not. In order to qualify as a low tax rate territory, the jurisdiction must meet several criteria, the main one being that the state or territory does not impose a tax on the profits earned or distributed by a legal person or such tax is less than one-third of the income tax which a natural person who is an Estonian resident would have to pay on a similar amount of business income, without taking into account the allowed deductions.

There are no thin capitalization rules.

#### **9. Which are the main administrative requirements to comply with the local tax authorities?**

The main administrative requirements with respect to corporate income tax are:

- by the 10<sup>th</sup> day of each month the resident legal person must file a tax return regarding taxable payments made during the previous month;
- by the 10<sup>th</sup> day of each month the resident legal person must transfer the amount of income tax payable for the previous month to the bank account of the tax authority;
- various notification requirements apply, in particular: obligation of the resident legal persons to submit annual reports to the tax authority, unless they are obligated by law to file them with the Commercial Register; obligation to notify the tax authority regarding various categories of payments, including payments to shareholders upon redemption of shares, reduction of share capital and payment of liquidation proceeds; obligation to notify of interest payments made to EU resident individuals; etc.

**10. With which countries have double taxation conventions already been concluded?**

Please see Appendix 2.

**11. Are there any special laws providing tax incentives to certain taxable entities?**

There are no specific tax incentives with the aim to promote inbound investment.

**C. Individuals****1. Which are the taxable persons?**

Taxable persons are resident and non-resident individuals. Resident individuals are subject to income tax on their entire worldwide income less deductions exhaustively stipulated in the Income Tax Act. Non-resident individuals are subject to tax on specific categories of income exhaustively stipulated in the Income Tax Act, further subject to applicable tax treaties.

An individual is an Estonian resident if his or her place of residence is in Estonia or if he or she stays in Estonia for at least 183 days over the course of a period of 12 consecutive calendar months. A person is deemed to be a resident as of the date of his or her arrival in Estonia.

**2. How is the taxable income specified?**

As noted above, resident individuals are taxed on their worldwide income, subject to applicable deductions. Main categories of income are salary, business income, capital gains, rental income and license fees, interest, dividends, pensions, insurance payments, etc.

There are a number of deductions and reliefs available. In particular, the basic exemption deductible from the income of a resident individual during a calendar year is 24 000 EEK (approx. 1 534 EUR). Also, a person maintaining a child, who maintains two or more minor children may deduct increased basic exemption from his or her income for each child of up to 17 years of age, starting with the second child.

A resident natural person has the right to deduct interest payments made to, *inter alia*, a credit institution which is a resident of a Contracting State, for a loan or finance lease taken in order to acquire a house or apartment for him/ herself. Interest payments for a loan or lease taken in order to acquire a plot of land in order to build a house may be deducted from income under the same conditions.

Payments to supplementary pension funds may also be deducted, but no more than to the extent of 15% of the taxable income, less the applicable deductions.

With respect to reliefs available for passive income, it should be mentioned that although income tax is charged on all dividends and other profit distributions received by a resident individual from a foreign legal person, such dividends are fully exempt if income tax has been paid on the share of profit on the basis of which the dividends are paid or if income tax on the dividends has been withheld in a foreign state. With respect to interest, income tax is not charged on interest

paid to individuals by an EEA resident credit institution or through or on account of a PE of a foreign credit institution located within the EEA.

Note that the deductions available to resident individuals are altogether limited to 50 000 EEK per taxpayer per calendar year, and to not more than 50 per cent of the taxpayer's income of the same period, after the deductions relating to business have been made.

The deductions available to resident individuals can be made from the income subject to taxation in Estonia also by other European Union resident individual who derived at least 75% of his or her taxable income in Estonia and who submits an income tax return of resident individual. Taxable income means income before deductions pursuant to the legislation of the state concerned.

### **3. What are the applicable tax rates?**

The general tax rate applicable to individuals is 22% (subject to decrease down to 21% as of 01.01.2008 and 20% as of 01.01.2009). Certain items of income are subject to reduced income tax rate: namely, supplementary funded pension payments meeting certain criteria are subject to income tax at 10%. Certain items of income, such as salary for working abroad, provided that the person has stayed in the foreign state for the purpose of employment for at least 183 days over the course of a period of 12 consecutive calendar months, and the specified income has been the taxable income of the person in the foreign state and if this is certified with a written certificate and the amount of income tax is indicated on the certificate (even if the amount is zero).

### **4. Are capital gains taxed separately?**

Capital gains are a category of income subject to individual income tax. The applicable tax rate is 22%, i.e. the generally applicable individual income tax rate.

Income tax is charged on gains from the sale or exchange of any transferable and monetarily appraisable objects, including real or movable property, securities, registered shares, etc. Please note that payments to shareholders upon reduction of share capital and redemption of shares, and liquidation proceeds are also taxable as capital gains.

Certain capital gains are exempt from income tax, such as property returned in the course of ownership reform, gain from transfer of property in personal use, gain from the exchange of a holding (shares, contributions) in the course of a merger, division or transformation of companies or non-profit co-operatives, gain from the increase or acquisition of a holding (shares, contributions) in a company by way of a non-monetary contribution, etc.

### **5. May losses be carried forward or back?**

With respect to sole entrepreneurs, losses may be carried forward for seven calendar years.

With respect to all resident individuals, losses from sale of securities may be carried forward and deducted from future capital gains received from sale of securities. Such losses may be carried forward indefinitely.

## **D. Capital**

### **In outline, which are the main taxes on capital, if any?**

There are no capital, inheritance or gift taxes under Estonian tax laws.

The only property tax imposed in Estonia is land tax, the rate of which generally varies between 0,1% and 2,5% of the taxable value of the land per year. Subject to certain specific exceptions, the owner of the land is liable for land tax.

## **E. Indirect taxes**

### **In outline, which are the main indirect taxes, if any?**

Indirect taxes introduced in Estonia are VAT and excise duties (alcohol, tobacco, fuel and package excise duties).

Estonian VAT rules are generally in line with the Sixth VAT Directive and other VAT Directives. Tax is charged on supplies of goods and services in the course of business activities and self-supply of goods and services. The threshold for obligatory registration as a taxable person is 250 000 EEK (approx. 15 978 EUR).

The standard rate of VAT is 18%, in certain cases reduced rates of 5% and 0% (i.e. exemption with the right to deduct input VAT) apply. Supplies taxable with 5% VAT includes books (except books for education), medicinal products, funeral requisites and services, etc. The VAT rate is 0% for exports, intra-Community supply, Community goods placed under tax warehousing arrangements, etc. Exempted goods and services are postal, health and social services, as well as supplies of immovables (the latter subject to certain exceptions).

Alcohol excise rates meet EU minimum levels. Tobacco excise rates do not correspond to EU minimum rates, and therefore Estonia has been granted a transitional period for reaching the EU minimum levels by 2008. With regard to fuel products, Estonia has been granted various transitional periods to meet the EU minimum levels as set forth in the Energy Taxation Directive.

Excise on packaging is imposed on packaging filled in Estonia, acquired from another Member State or imported into Estonia. Excise is paid by the importer of packages, by the user of packages, i.e. who fills packages with goods or by the person, who acquired packaging from another Member State upon the sale, exchange, free transfer or use for self-consumption of packaging.

## **F. Other duties**

### **In outline, are there any other taxes, if any?**

An important source of state revenue is, besides individual and corporate income tax and VAT, social tax. Social tax is charged on employers' payments to natural persons (wage income) in cash

as well as in kind (fringe benefits), and is a tax payable by employers. Minimum and maximum thresholds are set for social tax payable by sole proprietors.

Social tax rate is generally 33%, and in certain specific cases 13% of the taxable amount. Taxes are due monthly; the tax is paid by the 10th day of the following month. Taxable period for business income of sole proprietors is a calendar year.

## **G. Enforcement- Litigation procedure**

### **1. In outline, which are the existing measures in order to ensure compliance with the tax legislation?**

If a taxpayer fails to pay tax by the due date prescribed by law, the taxpayer is required to calculate and pay interest on the amount of tax outstanding by the due date. Interest shall be calculated as of the day following the day on which payment of the tax was due pursuant to law until the date of payment or set-off, inclusive of the latter. The rate of the interest is 0,06% per day of delay, or approx. 21,9% per annum.

Failure to perform non-monetary obligations of the taxpayer is secured by penalty payments and substitutive enforcement. In particular, in case of failure to submit documents or information, the tax authority may charge a penalty payment. Penalty payments imposed to enforce the performance of the same obligation must not exceed 40 000 EEK (approx. 2 556 EUR) in total. Substantive enforcement may be applied if, for example, the taxpayer fails to install meters on storage facilities or equipment according to the instructions of the tax authority.

Failure to comply with tax laws may trigger misdemeanour or, in certain cases, criminal liability. In particular, miscalculation of tax or failure to withhold tax amounts to a misdemeanour offence, punishable, in case of a legal person, with a fine of 50 000 EEK (approx. 3 196 EUR). Fraudulent miscalculation of tax, if a punishment for a misdemeanour has been imposed on the offender for the same act, or if such act results in a tax underpayment, or tax return, set-off or compensation without legal basis in the amount of 500 000 kroons or more, may trigger criminal liability. Punishment for such offence, in case of a legal person, may amount up to 250 000 000 EEK (approx. 16 000 000 EUR). In practice, however, the fines imposed have so far been significantly lower than the above upper limit.

### **2. What is on average the duration of the litigation procedure for the final resolution of tax disputes?**

A tax assessment may be disputed by submitting a challenge with the Tax and Customs Board. Alternatively, a tax assessment may be disputed directly by filing an action with the administrative court. A ruling on the challenge by the tax authority may also be disputed by filing an action with the administrative court. The court system consists of three stages, i.e. ruling by the administrative court may be disputed in the District Court, which is the appellate court instance, the decisions of which may, in turn, be disputed by appealing to the Supreme Court.

The duration of the litigation procedure may vary and depends greatly on the nature of the case. However, a dispute typically takes approximately six months to one year to pass all possible court instances and reach a final non-appealable decision.

**INCOME TAX RATES**

<b>Corporations</b>	<b>Partnerships</b>	<b>Individuals</b>	<b>Other entities</b>
22/78 of the net amount (i.e. 22% of the gross amount)	22/78 of the net amount (i.e. 22% of the gross amount)	22%	22/78 of the net amount (i.e. 22% of the gross amount)
		10% (supplementary pension fund payments)	

**LIST of DTC AGREEMENTS**

<b>Country</b>	<b>Interest withholding tax rate</b>	<b>Royalties withholding tax rate</b>	<b>Dividends Withholding tax rate</b>
Armenia	10%	10%	5% (at least 10% holding)/15%
Austria	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 25% holding)/15%
Belarus	10%	10%	10%
Belgium	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 25% holding)/15%
Canada	10%	10%	5% (at least 25% holding)/15%
China	10%	10%	5% (at least 25% holding)/10%
Croatia	10%	10%	5% (at least 10% holding)/15%
Czech Republic	10%	10%	5% (at least 25% holding)/15%
Denmark	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 25% holding)/15%

<b>Country</b>	<b>Interest withholding tax rate</b>	<b>Royalties withholding tax rate</b>	<b>Dividends Withholding tax rate</b>
Finland	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 25% holding)/15%
France	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 10% holding)/15%
Germany	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 25% holding)/15%
Hungary	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 25% holding)/15%
Iceland	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 25% holding)/15%
Ireland	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 25% holding)/15%
Italy	10%	5% (the royalties paid for the use of industrial, commercial or scientific	5% (at least 10% holding)/15%



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Country	Interest withholding tax rate	Royalties withholding tax rate	Dividends Withholding tax rate
		equipment) 10% (all the other cases)	
Kazakhstan	10%	15%	5% (at least 25% holding)/15%
Latvia	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment) 10% (all the other cases)	5% (at least 25% holding)/15%
Lithuania	10%	10%	5% (at least 20% holding)/15%
Luxembourg	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment) 10% (all the other cases)	5% (at least 25% holding)/15%
Malta	10%	10%	5% (at least 25% holding)/15%
Moldova	10%	10%	10%
Netherlands	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment) 10% (all the other cases)	5% (at least 25% holding)/15%
Norway	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment) 10% (all the other cases)	5% (at least 25% holding)/15%
Poland	10%	10%	5% (at least 25% holding)/15%
Portugal	10%	10%	10%
Romania	10%	10%	10%
Slovakia	10%	10%	10%
Slovenia	10%	10%	5% (at least 25% holding)/15%



THE WORLD'S LEADING ASSOCIATION OF INDEPENDENT LAW FIRMS

<b>Country</b>	<b>Interest withholding tax rate</b>	<b>Royalties withholding tax rate</b>	<b>Dividends Withholding tax rate</b>
Spain	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 25% holding)/15%
Sweden	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 25% holding)/15%
Switzerland	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 20% holding)/15%
Turkey	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	10%
Ukraine	10%	10%	5% (at least 25% holding)/15%
United Kingdom	10%	5% (the royalties paid for the use of industrial, commercial or scientific equipment)  10% (all the other cases)	5% (at least 25% holding)/15%
United States	10 %	5 % (the royalties paid for the use of industrial, commercial or scientific equipment)  10 % (all the other cases)	5% (at least 10% holding)/15%