The Estonian corporate income tax system

The material is provided by our Estonian colleagues from SORAINEN

Author: Allar Jõks

The Estonian corporate income tax system is quite distinguished. The reason for this is that there is no conventional corporate income tax and the profits are taxed at the moment of their distribution. Therefore, the income tax shall be paid only on distributed profits, fringe benefits, expenses and payments that are not related to business, gifts, donations and representation expenses. Additionally reduction of corporate capital, repurchases of shares and disbursement of liquidation is taxed in the part which proceeds the monetary and non-monetary contributions to the company's equity.

The Estonian Tax and Customs Board has given a good and brief overview of the corporate income tax system in Estonia. There are two types of profit distribution possible – an implicit and an explicit way. The explicit way stands for dividends and other profit distributions (except for bonus issue, which is taxable for resident natural persons upon the alienation of assets received through the bonus issue). Payments upon proceeds from liquidations, payments upon capital reductions and redemption or return of participation in a company are generally subject to corporate income tax in the hands of the payer: an Estonian company at the moment of distribution. The implicit way to distribute profits is to do that through fringe benefits, gifts and donations, as well as expenses and payments unrelated to business activity.

All of these profit distributions are taxed at a rate of 21/79 (or slightly over 26,6%). This tax rate should not be deceiving. It is still the same rate of 21% as in the provisions for the taxation of salaried work payments. The difference is that 21% is applied to gross payments and 21/79 is applied to net payments. (Starting from 2015 the rate will be 20%)

The resident legal person and the non-resident legal person acting through its permanent establishment registered in Estonia carrying out profit distribution has to pay 21/79 of the amount of profits distributed. For the recipient, dividends are not taxable income and additional income tax shall not be withheld on the amount of dividends.

Here are some examples given by the Estonian Tax and Customs Board of dividend taxation.

- A resident legal person pays 10 000 EUR of dividends to a natural person. A tax of 2658,23 EUR (10 000 x 21/79) has to be paid by the resident legal person.

- A resident legal person pays 10 000 EUR of dividends to a non-resident legal person who owns less than 10% of the profit-distributing entity. A tax of 2658,23 EUR (10 000 x 21/79) has to be paid by the resident legal person.

- A resident legal person pays 10 000 EUR of dividends to a resident legal person, who owns less than 10% share in the profit-distributing entity. A tax of 2658,23 EUR (10 000 x 21/79) has to be paid. When the receiving entity pays out dividends further to other persons, then the tax of 21/79 of the amount paid out has to be paid again.

- A resident legal person pays 10 000 EUR of dividends to resident legal person, who owns more than 10% share in the profit-distributing entity. A tax of 2658,23 EUR (10 000 x 21/79) has to be paid. When the receiving entity pays out dividends further to other persons, then the tax of 21/79 of the amount paid out shall not be paid.

There are tax exemptions available for resident legal persons and non-resident legal persons acting through its permanent establishment in Estonia. In some cases the income tax (21/79) is not charged on dividends or on payments upon a reduction in share capital or contributions and redemption of shares or liquidation of a legal person. The threshold for the application of participation exemptions is 10%.

The income tax (21/79) is not charged on dividends if:

- the resident company paying the dividend has derived the dividend which is the basis for the payment from a resident company of a Contracting State of the European Economic Area or the Swiss Confederation taxable with income tax (except for companies located within a low tax rate territory) and at least 10 % of such company's shares or votes belonged to the company at the time of deriving the dividend;

- the dividend is paid out of profit attributed to a resident company's permanent establishment located in a Contracting State of the European Economic Area or Swiss Confederation;

- the company paying the dividend has derived the dividend which is the basis for payment from a company of a foreign state not specified in first point (except for a company located within a low tax rate territory) and at the time of deriving the dividend, the company owned at least 10 % of the shares or votes of such company, and income tax has been withheld from the dividend or income tax has been charged on the share of profit which is the basis thereof;

- the dividend is paid out of the profit attributed to a foreign permanent establishment of a resident company and such profit is subject to income tax.

A resident company shall pay income tax on the payments made from the equity which exceed the monetary and non-monetary contributions paid into the equity of the company. These payments are exempted from income tax on the same grounds as are the dividends specified in previous listing.

When a resident company or a non-resident legal person acting through its permanent establishment in Estonia has received payments from abroad, the income tax paid abroad may be deducted from the taxable amount of profit distributed in Estonia. Income tax paid in a foreign state on the income which was the basis of the payment not taxable in Estonia shall not be taken into account for deduction.

More on the practical side the disputes on corporate income tax in Estonia are quite frequent. Prevailingly there are disputes about putting money aside from companies because money is taken out from the company under wrong description. Income tax shall not be paid when a payment related to business is made. Some companies are taking advantage of this condition and mask non-business related payments as business-related and thus will not pay income tax. This scheme is quite common. For example, investments or loans which will never be paid back or when companies are allegedly selling products to each-other but actually no products are being sold and money is just moved from one company to another. These are the basic ways and risks which companies use to avoid the respective law in Estonia.

This model is very convenient for businesses because there are ways in which they do not have to pay income tax. On the other hand this model also helps to promote business and accelerate economic growth by making additional funds available for investment. This way investors are be offered incentives to reinvest profit into the extension and development of their businesses in Estonia.