

Estonia is well known with its highly developed IT solutions in both public and private sectors and unique income tax system for legal entities. It is possible to register online a new legal entity (private limited company: *osaühing*: without making contributions for the shares upon foundation) in approximately 5 minutes and start doing business.<sup>1</sup> As to the income tax system of legal entities, the taxable event has been shifted from the retained earnings (as classical systems do) to the moment of distribution of profit.

However there are a number of issues which you must consider when you are looking to set up your business in Estonia. This document takes you through some of the common questions we come across and gives you practical information about the issues you need to consider.

### **What type of Business Structure should we use?**

There are advantages and disadvantages to all of them, and there is no one correct answer, it's all dependent on your specific business circumstances and needs. A brief overview of the main structures is below:

#### **Establishment (a branch of your overseas business)**

- Not a separate legal entity but an extension of the overseas parent company
- No limited liability or ring-fencing of the Estonian operations
- If have a permanent establishment in Estonia then profits which have been taken out of the permanent establishment during a period of taxation in monetary or non-monetary form, are liable to Estonian Corporate income tax
- Must file **parent company accounts** (an annual report), prepared under parent company's domestic Company Law, to commercial register for public inspection. The requirement for submission of reports does not apply to companies of the states which are Contracting Parties to the EEA Agreement if the legislation of the country of the registered office of the company does not require the annual report to be disclosed.

#### **Public Limited Company (aktsiaselts):**

- Share capital shall be at least 25 000 euros
- Provides limited liability and ring-fencing to Estonian operations
- Gives a perception of a local business, with longevity
- Corporate income tax to be paid on company's distributed profits
- Legal person is a resident if it is established pursuant to Estonian law
- Have to file annual report to commercial register
- Annual report always requires auditing.

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<sup>1</sup> Portal for registering: [www.rik.ee/en/company-registration-portal](http://www.rik.ee/en/company-registration-portal).

# Setting up your Business in Estonia

## Issues to consider



### Private Limited Company (*osaühing*):

- Share capital shall be at least 2500 euros
- If the planned share capital of a private limited company is not larger than 25 000 euros, the memorandum of association may prescribe that the founders are not required to pay for the share upon the foundation. Founder in that case must be exclusively a natural person
- Provides limited liability and ring-fencing to Estonian operations
- Gives a perception of a local business, with longevity
- Corporate income tax to be paid on company's distributed profits
- Legal person is a resident if it is established pursuant to Estonian law
- Have to file annual report to commercial register
- An audit of the annual accounts is compulsory for accounting entities in whose annual accounts at least two of the indicators of the financial year exceed the following conditions:
  - 1) sales revenue or income 4,000,000 euro;
  - 2) total assets as of the balance sheet date 2,000,000 euro;
  - 3) average number of employees 60 people;or at least one of the indicators of the financial year exceeds the following conditions:
  - 1) sales revenue or income 12,000,000 euro;
  - 2) total assets as of the balance sheet date 6,000,000 euro;
  - 3) average number of employees 180 people.

### Partnerships:

- There are two types of partnerships: a general partnership (*täisühing*: partners are solidarily liable for the obligations of the general partnership with all of their assets) and a limited partnership [*usaldusühing*: at least one of the partners (general partner) is liable for the obligations of the limited partnership with all of the general partner's assets, and at least one of the partners (limited partner) is liable for the obligations of the limited partnership to the extent of the limited partner's contribution].
- Partnerships are legal persons, thus Corporate income tax is to be paid on company's distributed profits
- A partnership is a resident if it is established pursuant to Estonian law
- Have to file annual report to commercial register (unless partners are all natural persons)
- As to the auditing liability of the annual accounts, the same conditions as to the private limited company apply.

### How much Corporation Tax will the business pay?

Corporate Income Tax rate in Estonia is 20/80 calculated of the net amount of the distribution.

Corporate income tax is not a classical one, but rather profit distribution tax as the profit itself

## Setting up your Business in Estonia Issues to consider



(whatever kind or from whatever source) is not taxable as long as it is not “taken out”. Upon distribution, tax is levied at a rate 20/80 of the net amount of the distribution.

The taxable base includes fringe benefits (those are not taxable in the hands of the receiver), gifts, donations, entertainment expenses, dividends, profits adjustments, non-business expenses.

Losses have no significance for income tax purposes and profit distributions are subject to income tax irrespective of the company’s accounting loss.

Permanent establishments pay corporate income tax similarly to legal persons. Separate entity approach applies. Income tax is imposed on profit attributed to permanent establishment which has been taken out of the permanent establishment during a period of taxation in monetary or non-monetary form. All fringe benefits granted by a non-resident to its employees or members of the management or controlling body through or on account of its permanent establishment are subject to income tax and social tax. Gifts and donations made and costs of entertaining guests incurred by a non-resident through or on account of its permanent establishment are subject to income tax (certain tax exemptions apply).

### **What if we use Estonia to set up our holding company?**

Dividends paid by resident legal persons are generally subject to corporate income tax of 20/80. No taxation applies if dividends are distributed out of the dividends received from EU, EEA or Swiss resident subsidiary provided 10% participation threshold is met. In case of dividends received from any other country, exemption applies provided the dividends or underlying profits have been subject to some taxation abroad. If the proportion of shares is lower than 10%, double taxation occurs, unless dividends come from non-resident company. In latter case, holding can deduct the income tax paid or withheld from such income abroad from the income tax payable on dividends.

As the income tax system is built in such a way that the taxable event has been shifted from the retained earnings (as classical systems do) to the moment of distribution of profit, the articles of the tax treaties do not apply to those dividends, as the object of the tax is profit itself and the liability to taxation occurs on the level of the Company, not on the receiver of the dividends.

There is no additional withholding tax on distributed dividends.

Due to the special characteristic of Estonian income tax system, the system favours treasury companies. Any interest earned by Estonian companies is tax exempt as long as not distributed. There are no thin capitalisation rules in Estonia.

No exemption applies to disposals of group companies.

### **What if we make cross-border transactions between group companies?**

# Setting up your Business in Estonia

## Issues to consider



Estonia follows internationally recognized **Transfer Pricing** (TP) rules where cross-border or domestic trading and financial transactions between affiliated entities have to be conducted on an arm's length basis. The price and terms should be the same as if the transactions had been between completely independent parties.

As there is a distribution income tax, the system works a bit differently. If the price of a transaction concluded between a resident legal person and a person associated with the resident legal person differs from the market value of the above transaction, income tax shall be imposed on the amount which the taxpayer would have received as income or the amount which the taxpayer would not have incurred as expenses if the transfer price had conformed to the market value of the transaction.

If one party of the treaty pays income tax on transfer pricing adjustment, the other party can distribute profit the same proportion tax free to eliminate double taxation.

Typical transactions between affiliated entities that are covered by TP regulations are:

- Sale and purchase of goods
- Provision of management services
- Property rental charges
- Transfer of intangible assets e.g. trademarks, patents
- Sharing of knowledge, expertise, business contacts etc.
- Provision of financial support e.g. inter-group loans and charging a "market" interest on loans.

A business will need to prepare a Transfer Pricing Report proving the arm's length basis of transactions. The report will include a functional and risk analysis, analysis of the adopted pricing model and benchmarking of the arm's length basis.

TP regulations apply irrespective of the "size" of a entity, but only "large" entities need to undertake detailed TP analysis.

Documenting the determining of the market value of transfer prices shall follow the general requirements for documenting economic transactions. The additional requirements for documentation shall be applied:

- 1) for a resident credit institution, insurance undertaking and business association registered in a securities market;
- 2) if one transaction party is a person situated in a low tax rate territory;
- 3) for a resident business association having 250 or more employees including associated persons, or having a turnover or 50 million Euros or more including associated persons in the financial year preceding the transaction, or having a consolidated balance sheet total of 43 million Euros or more;
- 4) for a non-resident being active in Estonia via a permanent establishment and having 250 or more employees including associated persons or having a turnover or 50 million Euros or more including associated persons in the financial year preceding the transaction, or having a consolidated balance sheet total of 43 million Euros or more.

The prepared documents must convince the tax administrator that the taxpayer had reason to believe that the transfer price conforms to the market value. The documents to be presented to the tax administrator are divided as follows:

- 1) documents related to an international consolidated group, comprising a main file;
- 2) documents related to a legal person being a resident of Estonia or a non-resident person being active in Estonia via a permanent establishment and the transactions conducted by them, comprising state-specific documents.

If documents have been prepared in a foreign language, the taxpayer shall submit the documents to the tax administrator in the foreign language. The tax administrator may request a translation of the documents into Estonian language, assigning a reasonable deadline for submitting the translation.

### **What Employment Taxes and Social Security will need to be paid?**

If an individual is resident in Estonia, then they are subject to Estonian tax laws.

A natural person is a 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 shall be deemed to be a resident as of the date of his or her arrival in Estonia.

If the residency prescribed on the basis of an international agreement differs from the residency prescribed pursuant to law or if the international agreement prescribes more favourable conditions for taxation of income than those provided by law, the provisions of the international agreement apply.

There's no domestic tie-brake rule.

We would advise any new entrant to Estonia or person who spends time working in Estonia to take professional advice to determine whether they are Estonian tax resident.

### **Current Personal Income Tax rates in Estonia**

In Estonia, there is a flat income tax system and tax rate is currently 20%.

Employers and employees also have to pay Estonian social security contributions. There are 3 of them: a social tax (*sotsiaalmaks*), an unemployment insurance premium (*töötuskindlustusmakse*) and a contribution to mandatory pension fund (*kohustusliku kogumispensioni makse*).

Social tax is entirely employers obligation, tax rate is 33% and the tax base is payments to employees (*i.e. wages, incl. payments of remuneration to the members of the board, etc.*).

Unemployment insurance premiums are divided into two: employer's premium's rate is currently 0,8% and employee's premium's rate is currently 1,6%. Tax base coincides with

# Setting up your Business in Estonia

## Issues to consider



social tax. Employer has to withhold employee's part from his wage. Insurance premium is deductible (from employee's income) for income tax purposes. Employer's premium is calculated like social tax. Rates are being looked over yearly. Members of the board and council are not insured and the Unemployment Insurance Act doesn't cover them.

A contribution to mandatory pension fund is withheld from wages and it is deductible (from employee's income) for the income tax purposes. Tax rate is 2% and tax base coincides with social tax, but unlike social tax and unemployment insurance, it doesn't cover non-residents, but unlike unemployment insurance, it covers members of the board and council.

The obligation to make contributions arises on 1 January of the year following the year during which an obligated person attains 18 years of age, and extinguishes on 31 December of the year of the first redemption day of pension fund units belonging to the obligated person.

There are temporary arrangements due to economic depression concerning rates, but those arrangements do not concern any more new entrants of the mandatory pension fund scheme.

Estonia has a Reciprocal Agreement with Canada, Ukraine and Russia and EU countries (EU law covers) whereby when an overseas national of those countries is seconded to the Estonia for a defined period of time and continues to pay social security contributions in their home country, then the employer and employee are exempt from paying Estonian social security contributions.

### **What is Value Added Tax (VAT) and should the business be registered?**

VAT is a "goods and services tax" on supplies made, the standard rate of which is 20%. If a business makes taxable supplies in excess of € 16 000 (40 000 € from 2018) in 12 months as calculated from the beginning of a calendar year, then it **MUST** be registered for VAT.

There are three types of supply

- Taxable – must charge VAT on supplies, can reclaim input VAT
- Exempt – cannot charge VAT nor reclaim input VAT
- Outside the scope – not in the Estonian VAT system

The supply of most types of goods and services in Estonia would be classed as Taxable supplies. However when these supplies are made to companies which are outside of the Estonia, advice needs to be sought as to what rate of VAT, if any, to use.

If a Estonian entity sells goods (e.g. export) or provides services to its non EU parent then there is no VAT chargeable (0% rated) on this overseas supply, however on the basis that the supply would be VAT'able if made in Estonia then the entity will be able to reclaim all its input VAT.

As Estonia is EU member country, Directive 2006/112/EC on the common system of value added tax applies.

# Setting up your Business in Estonia

## Issues to consider



### **Can we provide Share option plans to our staff?**

Many companies see Share Option plans as being an important way of attracting, motivating and retaining key staff.

Estonia has a number of “approved” share option plans which give tax benefits to employees and employers alike and it is often possible to adapt an overseas stock option plan to fit into one of these “approved” plans.

However this is a very technically complex area and careful planning needs to be undertaken as soon as share option plans are being considered for implementation in Estonia.

### **How else can we compensate our employees?**

Estonia has a very narrow range of compensation and benefit options available for companies to offer their employees.

### **Kreston International**

Kreston International Limited is a global network of independent accounting firms with the reputation for providing trusted compliance and advisory services to entrepreneurial business in the SME and mid-market sectors.

Currently ranked as the 12th largest accounting network in the world, Kreston has a presence in over 100 countries, providing a resource of over 20,000 professional and support staff.

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