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Tax alert

Estonia, March 2020

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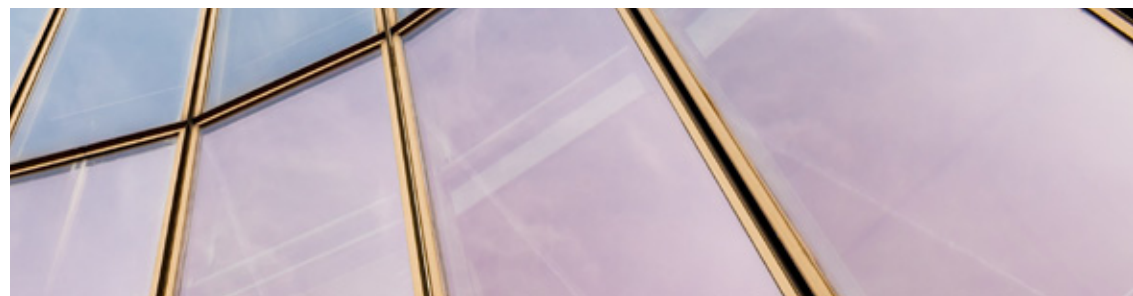
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Legal acts

Supreme Court decision nr 3-18-1740 on 4th March 2020

The Supreme Court ruled on a dispute between OÜ Vallaste and Partners (the applicant) concerning a tax assessment made by the Tax and Customs Board (MTA) in 2018, in which MTA found that the applicant's transactions with five of its subcontractors (A, B, C, D and E) were fictitious and therefore should be reclassified for tax purposes.

The tax audit targeted payroll taxes in 2016. The amount of tax arrears was estimated at approximately € 188,000, including income and social taxes as well as VAT (i.e. non-deductible input tax).

The proceedings before the Supreme Court were in favor for MTA. However, the original tax assessment was partially annulled by the Supreme Court.

Background and main proceedings

Three board members of the applicant's, while being at the same time shareholders of the applicant, received remuneration, which was declared and taxed accordingly. The board members also owned private limited companies A, B and C, which had subcontracting agreements with the applicant for various types of services (i.e. legal and tax consulting, software development, accounting services). The companies serviced the applicant's clients and in exchange received different types of fees from the applicant (fixed amount, performance reward, etc.).

In addition, the applicant also had contracts with private limited companies D and E, which provided accounting and tax services.

In essence, the applicant and the subcontractors were a group of companies operating under the business name Vallaste and Partners providing a comprehensive service, which included client relations / client contracts, office management and representation function. Among other things, the applicant substantiated this kind of franchise model being in place for more than 20 years.

There were significantly more subcontractors in this group, but only five of them became objects of interest for MTA.

MTA claimed that the actual subcontractors were the natural persons directly and not the companies and therefore the remuneration paid for the services purchased from A, B, C, D and E would have to be taxed either as director fees or salaries.

MTA applied § 83 (4') of the Taxation Act (MKS) regarding fictitious supplies as a legal basis for assessing the tax, rather than § 84, and upheld it in the Supreme Court. For the sake of clarity, § 84 of the Taxation Act concerns a situation where there is an abuse of freedom of contract for the purpose of obtaining a tax advantage.

Findings of the Supreme Court

The Supreme Court did not consider the transactions as fictitious

In fictitious transactions, the parties do not wish to conclude transactions and take the related rights and obligations. However, in this case, the parties wished the subcontractors A, B, C, D and E to carrying out the agreed work for which they were entitled to remuneration. Also, there were no indicators that the underlying intent of the parties was to provide respective individuals with the right to access and dispose cash.

The legal form of the contracts did not correspond to their economic content

Although the applicant's contracts with the companies A, B, C, D and E were not fictitious, the legal form of the contracts did not correspond to their economic content.

According to the Supreme Court, the purpose of the companies A, B, C D and E, which were controlled by the actual service providers, was to evade payroll taxes, thus obtaining a tax advantage and gather payments to the companies. The economic content of the transactions was paying salaries to the individuals for the work performed. Although it is permitted to take account of tax considerations in economic activities, it is not permissible, for tax purposes, to give the transaction a legal form which is distorted in relation to its economic content.

The Supreme Court decided that the applicant should have paid salaries to the individuals and then the individuals could have invested the remuneration received into their private companies.

Legal acts

A distinction must be made between salary and dividend income

The Supreme Court did not agree to fully reclassify the payments made to A, B and C as director fees, since the same persons were also shareholders of the applicant.

The applicant is entitled to pay dividends to its shareholder as a passive income subject only to income tax. MTA did not consider this aspect when making the tax assessment, MTA considered the entire remuneration as for active work performed.

In practice, it is unclear where the line between active and passive work should be drawn.

Neither the tax assessment nor proceedings in the court explained whether the applicant paid dividends, nor was it analyzed in detail whether the payments made to subcontractors A, B and C could fall under different types of income.

Therefore, the Supreme Court agreed with the applicant regarding the taxation of the fees paid to the A, B and C, which cannot be considered fully as those paid for an active income. Still the Supreme Court reclassified the fees paid to D and E as salaries paid to individuals.

Clarification of the circumstances of the Management Board member contract

The Supreme Court also clarified the circumstances of the board member's contract.

The Supreme Court disagreed that contracts between the applicant and the companies A, B and C, should be considered as board member agreements. Although the subcontracted companies performed tasks which fall within the scope of the board members specific area of responsibility, the board member has no legal obligation to perform any duties other than those provided for in the Commercial Code (representation, management and accounting).

A member of the board is not required, but may perform other functions as well, including the provision of services to clients, but in such a case there should be, for example, an employment contract in place.

Will the MTA continue to audit the correct reclassification of payments (payments being either active or passive type of income) made to companies A, B and C?

This will be decided soon by MTA.

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