Republic of Estonia
Tax and Customs Board

Specifications upon taxation with income tax

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Measures against evasion of profit taxation (ATAD)

We explain the measures against evasion of profit taxation, which are set out in the Income Tax Act and stem from Council Directive (EU) 2016/1164 (Anti-Tax Avoidance Directive, ATAD).

Legal basis

Income Tax Act

Council Directive (EU) 2016/1164

Based on the directive, the following sections are in the Income Tax Act:

- **§ 5^1 “Transaction for purpose of obtaining tax advantage”**
- **§ 54^1 “Income tax on transaction for tax advantage”**
- **§ 54^2 “Income tax on surplus borrowing costs”**
- **§ 54^3 “Income tax on profits of foreign controlled companies”**
- **§ 54^4 “Declaration and payment of income tax”**
- **§ 54^5 “Exit income tax”**

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§ 5^1 “Transaction for purpose of obtaining tax advantage” of the Income Tax Act

According to the general anti-abuse provision (**§ 5^1 of the Income Tax Act**), in the case of income tax, no account shall be taken of a transaction or chain of transactions

- the principal purpose of which or one of the principal purposes is to **obtain a tax advantage** which is contrary to the content or purpose of the applicable tax law or international agreement

- which **is not actual** having regard to all the relevant circumstances.

Both conditions must be met for the provision to apply.

A chain of transactions may consist of more than one intermediate stage or part (subsection 1 of § 5^1 of the Income Tax Act).

A transaction or chain of transactions is not considered actual **unless it is made for real vital or commercial reasons**, which reflect the actual economic substance of the transaction (subsection 2 of § 5^1 of the Income Tax Act).

Vital and commercial reasons are all circumstances other than those related to taxation.

A tax advantage is permissible if, considering all life and commercial circumstances, the transaction or chain of transactions would have been organised without the tax advantage.

A tax advantage is not permissible if, considering all the circumstances, the transaction or chain of transactions would not have been organised without receiving the tax advantage.

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§ 84 of the Taxation Act regulating tax evasion

In addition to § 5^1 of the Income Tax Act, tax evasion is also regulated by **§ 84 of the Taxation Act**.

It lays down the so-called economic interpretation principle, which means that taxation is based on the economic content, not the legal form.

According to this provision, where it is evident from the content of a transaction or action that the transaction or action is performed for the purposes of tax evasion, conditions corresponding to the actual economic content of the transaction or action apply upon taxation.

Over the years, a number of income **tax disputes [1]** have reached the **court**, in which the formal compliance of transactions with their content and the occurrence of tax evasion in a specific situation have been assessed.

In general terms, the **Supreme Court [2]** has reached the following three conclusions.

- No one is obliged to organise their activities in a way that entails a higher tax burden.
- Tax planning is considered legal as long as the form of the taxable person's transaction corresponds to its actual economic content and the tax laws are followed.
- In the case of a natural person, it is tax evasion if the person receives income in economic terms and avoids tax liability by distorting the economic content of the transaction.

NOTES

[1] Disputes concerning the transfer of holdings of well-known Estonian companies have received the most coverage in the media. These are focused on the question of whether the transition of a holding to a company owned by a natural person immediately before the transfer of the holding and the accompanying deferral of the tax liability of the income from the transfer of the holding can be treated as tax evasion or not. **Back to text**

[2] Clauses 13 and 14 of the **disposition 3-3-1-15-11 of the Supreme Court**. **Back to text**

Last updated on 08.01.2025

What is the difference between § 5¹ of the Income Tax Act and § 84 of the Taxation Act

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Section 5[1] of the Income Tax Act

The most important difference between the provisions is that, **under § 5[1] of the Income Tax Act, the tax payer incurs a tax liability as soon as they have made a transaction in which at least one of the main objectives (not the only objective!) is to obtain a tax advantage (not tax evasion!) regardless of the content and form of the transaction (the form and content of the transaction may be compatible!).**

Therefore, based on § 5[1] of the Income Tax Act, any transaction is subject to declaration and taxation with income tax, in which one of its purposes is to obtain a tax advantage and the actual content and form of the transaction are compatible with each other.

Section 84 of the Taxation Act

On the other hand, the application of § 84 of the Taxation Act and taxation based on it also requires the identification of the real economic content of the transactions, and the said provision can be applied only if the transaction was made for the purpose of tax evasion.

Depending on the transaction, it is subject to declaration, based on the content, in the correct Annex of the tax declaration form TSD.

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Example of the use of anti-abuse clauses

To help taxpayers, the tax authority and courts, the authors of the bill have added examples to the explanatory memorandum of the Income Tax Act of situations which could be taxed in Estonia in the future in light of the change in the way of thinking of international taxation described above.

For example, the provisions can be applied in a situation where royalties are paid from Estonia to a company resident in country A. Tax treaty reduces the rate of the tax to be withheld under the Income Tax Act. After some investigation, it turns out that the company of country A is a link between residents of Estonia and country B to reduce the income tax to be withheld. There is no valid tax treaty between Estonia and country B. In such a case, based on the general anti-abuse provision, it is possible to refuse to apply the contract of country A, and income tax must be withheld from the royalties at the usual rate under the Income Tax Act.

It is important to emphasise that, based on both § 84 of the Taxation Act and the Income Tax Act, **no transaction is taxed, the purpose of which is not to obtain a tax advantage.**

For example, companies will continue to have every opportunity to pay and receive royalties, and natural persons will continue to be able to use their assets in any way to generate income as a private person, self-employed person (in Estonian *füüsilisest isikust ettevõtja*, FIE) or through a company. The amendment to the Income Tax Act will only eliminate the tax advantages of those taxpayers who knowingly create schemes to receive tax advantages that are not meant for them.

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International tax environment

For many years, international tax policy has been focused on avoiding cross-border double taxation (for example, the **OECD Model Tax Convention** and the European Union (EU) **directive on dividend taxation of parent companies and subsidiaries of different Member States)**.

At the initiative of the G20 and under the leadership of the OECD, a fundamental change in the way of thinking took place in 2013, when the **international project against Base Erosion and Profit Shifting (BEPS)** was launched, to which more than 135 countries and jurisdictions have joined.

The first change carrying an international approach took place in the referenced EU parent and subsidiary company directive, to which a general anti-abuse provision was added in 2015. According to this, Member States will not grant the benefits of the Directive to an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the Directive, are not genuine having regard to all relevant facts and circumstances. In Estonia, this amendment was adopted in 2016 by supplementing § 50 of the Income Tax Act with **subsection 1^4**.

In 2016, the EU agreed on the **Anti-Tax Avoidance Directive (ATAD)**, the **Article 6** of which extended the general anti-abuse provision from dividends to all aspects of corporate income tax. According to this, a Member State will ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. Estonia had the obligation to adopt the said provision into domestic law by the end of 2018.

In 2016, the OECD agreed on a **Multilateral Instrument (MLI)** to implement tax treaty related measures, which extends the general anti-abuse provision to all taxes and taxpayers covered by tax treaties. According to this, a benefit under a tax treaty shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit. Estonia has signed the MLI and its ratification took place in 2019.

In summary, since the launch of the BEPS project in 2013, all international attention has been focused from avoiding double taxation to paying taxes – fewer and fewer ways to optimize taxes are considered legal, and the limits of legal tax optimization are becoming narrower and narrower, more emphasis is placed on achieving all kinds of tax advantages, not just on not paying taxes.

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§ 54¹ “Income tax on transaction for tax advantage” of the Income Tax Act

§ 54¹ of the Income Tax Act regulates the application of the general anti-abuse provision in the taxation of the profit of a resident company. If it has been established that it is a transaction or a chain of transactions:

- the principal purpose of which or one of the principal purposes is to **obtain a tax advantage** which is contrary to the content or purpose of the applicable tax law or international agreement and
- which **is not actual** having regard to all the relevant circumstances and
- which resulted in loss of income or excess expense to the taxpayer, then

the amount is taxed with income tax that the resident company would have received as income, or the amount that the resident company would not have incurred as an expense, if there had been no transaction or chain of transactions corresponding to the characteristics specified in **§ 5¹ of the Income Tax Act**.

DECLARATION AND PAYMENT OF INCOME TAX

Transactions made for the purpose of obtaining a tax advantage (§ 54¹ of the Income Tax Act) are subject to declaration. These are declared in part II of Annex 6 of the TSD tax declaration, where “622” (income not received or cost not made) must be entered as type on the code 6240.

The TSD declaration is submitted and the tax liability is paid by the 10th day of the month following the taxable period.

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§ 54² "Income tax on surplus borrowing costs" of the Income Tax Act

To reduce the overall tax burden, corporations have increasingly resorted to profit shifting through excessive interest payments.

To prevent such activity, the tax payer's deduction of the surplus borrowing costs is limited.

Considering the particularity of the Estonian income tax system, where the profit is taxed only when it is distributed, in Estonia, a restriction on the deduction of interest cannot be established, and therefore the **surplus borrowing costs [1]** are taxed similarly to other costs not related to business.

On the basis of **subsection 1 of § 54² of the Income Tax Act**, income tax is charged on the residual borrowing costs of a resident company, other than a financial undertaking, in excess of

- 3 000 000 euros and
- 30 per cent of the interest, tax and profit before depreciation of a resident company (hereinafter profit before depreciation)

in the portion exceeding the losses of the resident company, **unless:**

1. a resident company is not part of a consolidated group for financial accounting purposes and has no affiliated company or permanent establishment, or
2. the loan is used to finance long-term infrastructure projects of public sector involving both the project promoter, borrowing costs, assets and income in the European Union, or
3. a resident company that is a member of a consolidated group for financial accounting purposes will choose to apply subsection 8.

Therefore, a financial entrepreneur and a company that is not part of a consolidated group for financial accounting purposes and does not have an affiliated company or a permanent establishment do not have to pay income tax on the surplus borrowing costs. Also, in a situation where the loan is used to finance a long-term public sector infrastructure project.

NOTE

[1] Explanatory memorandum of the Income Tax Act, RT I, 28.12.2018, 44 – entry into force 01.01.2019. **Back to text**

Last updated on 08.01.2025

What are borrowing costs

In the meaning of the Income Tax Act, borrowing costs are deemed to be interest expenses of any debt obligation and other costs that are economically equivalent to interest and expenses incurred in raising funds, including:

1. payments on profit-sharing loans;
2. estimated interest accrued on convertible bonds and zero coupon bonds;
3. amounts received under alternative financing arrangements;
4. part of financing costs of finance lease payments;
5. capitalized interest that is included in the carrying amount of the related asset or capitalized interest depreciation expense;
6. amounts corresponding to the return on financing calculated on the basis of the market value principle;
7. the conditional interest arising on the borrowing-related derivatives or hedging arrangements of the entity concerned;
8. exchange rate gain or loss arising from borrowing and involvement of funds instruments;
9. guarantee fees for financing agreements, management fees and similar costs related to borrowing of funds. (**Subsection 2 of § 54^{2} of the Income Tax Act**)

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What are surplus borrowing costs

The residual borrowing cost is the amount by which the deductible borrowing costs of a resident company exceed interest income and other taxable income which is economically equal (**subsection 2 of § 54^2 of the Income Tax Act**). Interest income and other economically equivalent taxable income is income arising from debt claims.

The calculation of surplus borrowing cost is done a cash basis, i.e. the borrowing cost is compared with cash-based interest income. The surplus borrowing cost is if, based on the income statement, the cost of borrowing on a cash basis is greater than the interest income.

Interest income is a so-called mirror image of the same types of income that are defined as the cost of loan use for the borrower.

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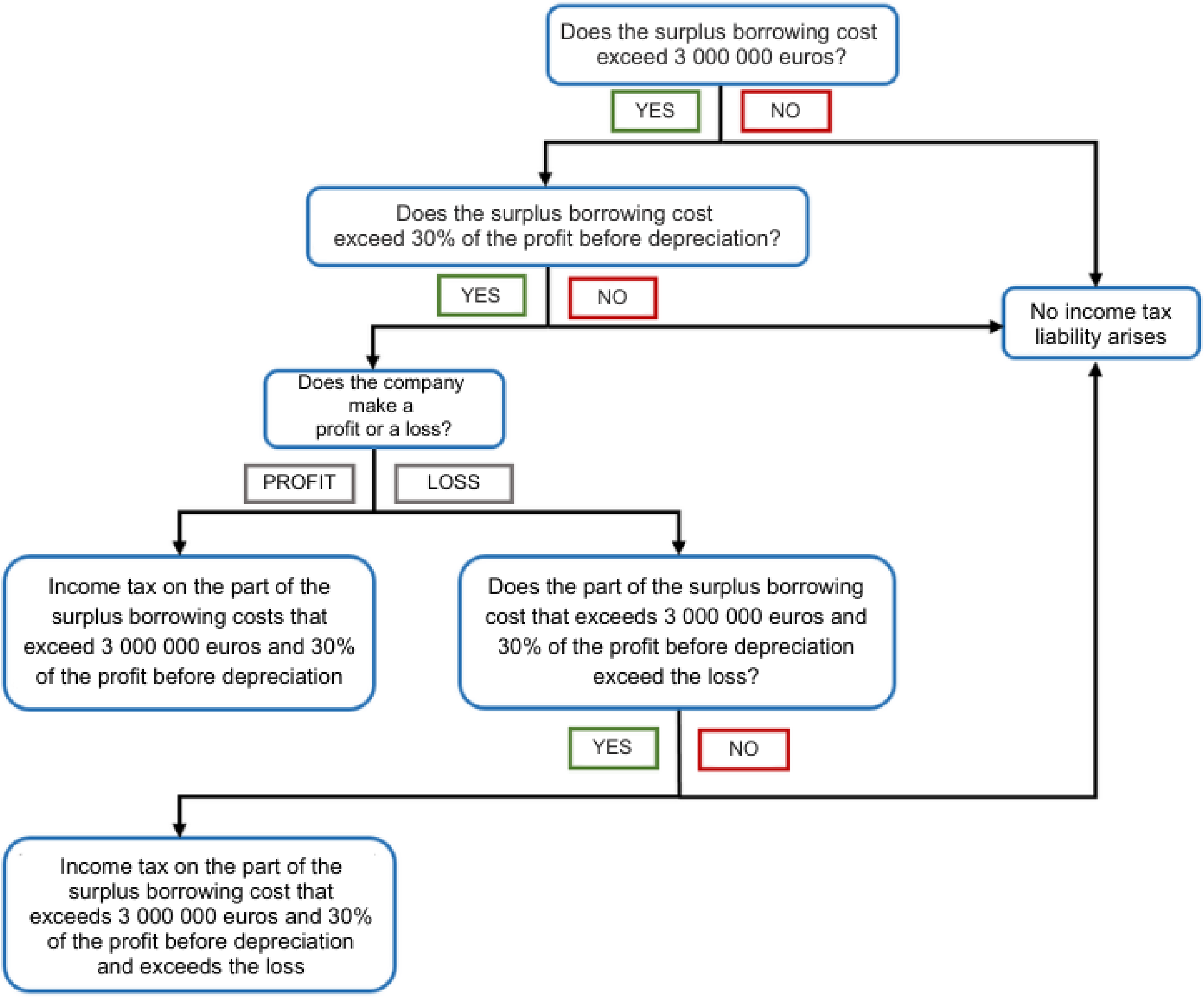
Taxation of the surplus borrowing cost



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Examples of taxation of the surplus borrowing cost

EXAMPLE 1

The company's profit before depreciation is 20 million euros, surplus borrowing cost is 10 million euros, and the company's net loss is 5 million euros.

The surplus borrowing cost exceeds the threshold of 3 million euros by 7 million and is 4 million euros higher than 30% of the company's profit before depreciation.

Since 4 million euros does not exceed the company's net loss (5 million euros), the company does not have a tax liability.

EXAMPLE 2

The company's profit before depreciation is 20 million euros, interest expense is 10 million euros, depreciation is 15 million euros, and the company's net loss is 3 million euros.

The interest expense exceeds the threshold of 3 million euros by 7 million and is 4 million euros higher than 30% of the company's profit before depreciation.

Since 4 million euros exceeds the net loss (3 million euros) by 1 million euros, the obligation to pay income tax on 1 million euros arises.

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What is a consolidated group for financial accounting purposes

A consolidated group for financial accounting purposes is a group consisting of all entities that are fully included in the consolidated financial statements prepared in accordance with International Financial Reporting Standards or the financial reporting framework of a Member State of the European Union (**subsection 4 of § 54^2 of the Income Tax Act**).

If a resident company is a part of a consolidated group for financial accounting purposes, it can **choose between two group exceptions** when taxing surplus borrowing costs. In order to use the exceptions, the conditions set forth in **subsections 8 and 9 of § 54^2 of the Income Tax Act** must be met.

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When can you choose the exception of the consolidated group for financial accounting purposes in the taxation of the surplus

borrowing costs (subsections 8 and 9 of § 54^2 of the Income Tax Act)

A resident company that is a member of a consolidated group for financial accounting purposes **may choose** that its excess borrowing cost is not taxed if it demonstrates that its equity-to-total assets ratio is equal to or greater than the equity-to-total assets ratio of the group, except financial undertakings belonging to the group, and if the following conditions are met:

1. the equity-to-total assets ratio of a resident company is considered to be equal to the equity and total assets ratio if the ratio of the equity of the resident company to the total assets is less than two percentage points below the group;
2. all assets and liabilities are valued with the same method as in the consolidated financial statements prepared in accordance with International Financial Reporting Standards or the financial reporting framework of a Member State of the European Union. (**Subsection 8 of § 54^2 of the Income Tax Act**)

A resident company that is a member of a consolidated group for financial accounting purposes may rely on a ceiling on excess borrowing costs higher than that provided for in **subsection 1 of § 54^2 of the Income Tax Act**. The higher residual borrowing cost limit is calculated in two stages:

1. the ratio is calculated by dividing the borrowing costs of the group incurred relating to third parties, with the exception of the financial undertakings of the group and the borrowing costs specified in clause 2 of subsection 1, by the pre-depreciation profit of the group, excluding financial undertakings belonging to the group;
2. the ratio obtained is multiplied by the pre-depreciation profit of the resident company. (**Subsection 9 of § 54^2 of the Income Tax Act**)

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What is an affiliated company

An affiliated company is:

1. an entity in which a resident company has a direct or indirect holding of at least 25 per cent of the voting rights or capital, or of who is entitled to at least 25 per cent of the profits of that taxpayer;
2. a natural person or entity having a direct or indirect shareholding of at least 25 per cent of the voting rights or capital of a taxpayer or who is entitled to at least 25 per cent of the profits of that taxpayer;
3. all entities concerned if the natural person or entity has a direct or indirect shareholding of at least 25 per cent in the taxpayer and in one or more entities. (**Subsection 5 of § 54^2 of the Income Tax Act**)

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What is a long-term infrastructure project of public sector

A long-term infrastructure project of public sector is a project aimed at providing, updating, operating or maintaining large-scale assets that a Member State of the European Union considers to be of public interest. (**Subsection 6 of § 54^2 of the Income Tax Act**)

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How is profit before depreciation calculated

Profit before depreciation is calculated by adding the amounts adjusted for taxation purposes to the taxable amount of the excess borrowing costs of taxable income and the adjusted depreciation and amortization amounts for taxation purposes. If there are no amounts adjusted for tax purposes, the accounting amounts shall be based on.

Pre-depreciation profit is excluding:

1. income exempt from income tax, including income on account of which the distributed profit is not taxed;
2. all the proceeds from the loan used to finance the entire long-term infrastructure project of public sector. (**Subsection 7 of § 54^2 of the Income Tax Act**)

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Income tax recalculation

If the residual borrowing costs of a resident company remain below the limit provided for in **§ 54^2 of the**

Income Tax Act during the taxation period, the resident company shall be entitled to make the income tax recalculation on the income tax paid on the loan borrowing costs in excess in the preceding taxable periods up to the limit provided for in § 54^2 of the Income Tax Act and demand repayment of the overpaid income tax. (**Subsection 10 of § 54^2 of the Income Tax Act**)

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Declaration and payment of income tax

Income tax on the surplus borrowing cost (§ 54^2 of the Income Tax Act) is subject to declaration in Annex 6 of the tax declaration form TSD with the code “6080”.

The TSD declaration is submitted and the tax liability is paid by the 10th day of the month following the taxable period.

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§ 54^3 “Income tax on profits of foreign controlled companies” of the Income Tax Act

According to **subsection 1 of § 54^3 of the Income Tax Act**, the portion of profits of a foreign controlled company

- resulting from the use of such assets and the assumption of risks associated with key employees of the controlling company and
- attributable to ostensible transactions the main purpose of which was to obtain a tax advantage

shall be attributed to the resident company and taxed as profits.

The profits of a foreign controlled company attributable to a resident company are calculated in accordance with the market value principle.

A transaction or a chain of transactions shall be deemed to be ostensible if the relevant entity or permanent establishment did not have the assets from which it receives all or part of its income, and it would not have assumed the corresponding risks if it was not controlled by the company where the function is executed related to the assets and key employees related to the risks, which is crucial upon earning the income of the controlled company. (**Subsection 2 of § 54^3 of the Income Tax Act**)

WHAT ARE CONSIDERED AS FOREIGN CONTROLLED COMPANIES

The following are considered as foreign controlled companies:

1. an entity in which a resident company, alone or together with its affiliated companies, has a direct or indirect shareholding of more than 50 per cent of voting rights or holds more than 50 per cent of the capital directly or indirectly or is entitled to more than 50 per cent of the profits of the entity concerned;
2. permanent establishment. (**Subsection 3 of § 54^3 of the Income Tax Act**)

Subsection 1 shall not apply to a resident company the profits of the controlled company of which for the previous financial year do not exceed 750 000 euros and whose other operating income, profits from subsidiaries, related companies and financial investments, interest income and other financial income do not exceed 75 000 euros in the same period.

DECLARATION AND PAYMENT OF INCOME TAX

Income tax on the surplus borrowing cost (§ 54^3 of the Income Tax Act) is subject to declaration in Annex 7 of the tax declaration form TSD with the code “7016”.

The TSD declaration is submitted and the tax liability is paid by the 10th day of the month following the taxable period.

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§ 54 “Exit income tax” of the Income Tax Act

If a taxpayer moves property or its residence out of the tax jurisdiction of a country, that country will tax the economic value of any capital gains generated in its territory, even if these gains have not yet been realized at the time of leaving the country. In other words, the taxpayer is subject to income tax upon departure and its unrealized capital gain, which is part of the moved property, is taxed.

Income tax is charged on the amount that is equal to the difference between the market value and carrying amount of the assets to be taken out at the time of exit of the assets from Estonia if a resident company takes assets to a permanent establishment in another Member State of the European Union or in a third country. (**Subsection 1 of § 54^{5} of the Income Tax Act**)

Income tax is not applied to taking out assets in connection with financing securities, assets posted as collateral or where the assets are taken out in order to meet prudential capital requirements or for the purpose of liquidity management if the assets are set to revert to Estonia within a period of 12 months. (**Subsection 2 of § 54^{5} of the Income Tax Act**)

Income tax may be paid in instalments over up to five years if:

1. a resident company takes out assets to a permanent establishment in a Contracting State
2. a resident company becomes a resident of another Contracting State. (**Subsection 3 of § 54^{5} of the Income Tax Act**)

The conditions of payments in instalments are stipulated **in sections 4–7 of § 54^{5} of the Income Tax Act**.

DECLARATION AND PAYMENT OF INCOME TAX

Exit income tax, i.e. assets taken out (§ 54^{5} of the Income Tax Act) are subject to declaration in Annex 7 of the tax declaration form TSD with the code “7014”.

The TSD declaration is submitted and the tax liability is paid by the 10th day of the month following the taxable period.

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