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The Compatibility of the Estonian Corporate Income Tax System with Community Law

The Estonian corporate income tax system (hereinafter 'CIT system'), effective from 1 January 2000, has merited substantial interest from tax law scholars by virtue of its peculiarity and difference from traditional CIT systems. This article is intended to give an overview of the advantages and drawbacks of the Estonian CIT system and to examine the compatibility of this system with the relevant EC law.

The article starts with presentation of the background of the Estonian CIT reform in 2000 and the reasons for the reform. It demonstrates how beneficial the new CIT system is both for the state and for the taxpayers. Furthermore, the article focuses on the problems associated with the Estonian CIT system and provides analysis of the compatibility of the system with EC law, especially Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries in different Member States*[1] (hereinafter referred to as 'the Parent–Subsidiary Directive'). Also, the relevant European Court of Justice (ECJ) case law is examined. Thereafter, changes in the Estonian CIT system for 2009 are discussed. Finally, the article introduces the CIT reform of 2008 in Moldova, in which the country decided to make its CIT system similar to the Estonian one and describes the essay competition in Germany concerning deferred taxation.

[1] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ 1990, L 225, p. 6) with further amendments.

1. The background to the Estonian CIT reform of 2000

The version of the Income Tax Act (hereinafter: ITA) that took effect on 1 January 2000*2 was the third Income Tax Act in Estonia following the nation's regaining of its independence in 1991. Until 1 January 1994, personal income tax and corporate income tax were stipulated in two different acts. On 8 September 1993, the Estonian Parliament had passed a new Income Tax Act, which regulated both personal and corporate income tax; this took effect on 1 January 1994. However, this act had been amended 34 times since then, and some of these changes undermined the taxable base, rendered application of the Income Tax Act ineffective, and threatened to distort competition.*3 It was, therefore, necessary to draft a new Income Tax Act.

On 1 January 2000, the new Income Tax Act came into force that stipulated the unique CIT system of Estonia. The main difference of the Estonian CIT system from traditional systems is that profits are not subject to tax at the moment when they are earned. Instead, taxation is deferred until the distribution of profits. Additionally, expenses not related to business and, therefore, not deductible in traditional CIT systems are subject to tax in the Estonian CIT system. Consequently, the difference from the traditional expression of the system is only technical (the timing of tax liability); however, the Estonian CIT system is easier to comply with both for taxpayers and for the tax administration.*4

The aim of the CIT reform of 2000 was to facilitate the development of enterprises and attract investors. This objective was undoubtedly achieved, as the profits of the companies have grown significantly.*5 Furthermore, because of the CIT reform, the unequal treatment of different legal persons was eliminated, since all tax incentives were abolished. As a result of the reform, there are no special rules favouring certain economic sectors, giving an incentive for investments in certain regions, or special tax incentives for foreign investors.

2. Advantages of the Estonian CIT system

The main merit of the Estonian CIT system is that it is simple and easy to both understand and administer, by virtue of its minimum number of exceptions and deferral of taxation of profits from the moment when they are earned till their distribution. Such a difference in timing enables preservation of all substantial elements of a traditional CIT system and at the same time to reduce considerably the number of technicalities from that required in a traditional CIT system.

Under a traditional system, in order to establish the taxable amount, the commercial profits are, first of all, calculated according to the accounting rules; then they are adjusted on the basis of the tax rules (e.g., certain expenses increase the taxable amount). In Estonia, distributed profits reflect the commercial profits and, additionally, non-deductible expenses are taxed on the cash basis. So, the only difference seems to be in timing; however, the Estonian CIT system has a considerable advantage — there is no need for amortisation and depreciation rules.

Moreover, since the Estonian Commercial Code*6 stipulates that profits can be distributed with the proviso that there are no losses from previous years (§ 276 of the Commercial Code), there is no need for special rules regulating carrying forward of losses. If the company has losses from previous years, the profits cannot be distributed and, therefore, are not subject to tax.

Additionally, the distributed profits and payments taxable on the corporate level are not subject to personal income tax on the level of the recipient. Therefore, double taxation is fully avoided. Furthermore, as natural persons do not have a liability to declare such payments, the number of tax returns submitted, as well as that of possible mistakes and corrections of tax returns, is reduced. Consequently, the administrative burden and compliance costs are also reduced. Because of these advantages, most corporate taxpayers are satisfied with the Estonian CIT system and would not like it to be changed.*7

2 Tulumaksuseadus. – RT I 1999, 101, 903; 2007, 44, 318 (in Estonian). English translation available at http://www.just.ee/23295 (21.07.2008).

3 L. Lehis. Tulumaksuseadus. Kommenteeritud väljaanne (Income Tax Act. Commented edition). Tartu: OÜ Casus 2000, p. 10 (in Estonian).

4 See also A. Kurist, E. Uustalu. National Report (Estonia) for IFA Sydney Congress 2003 Subject I. – Trends in Company / Shareholder Taxation: Single or Double Taxation. Cahiers de droit fiscal international. Kluwer 2003, pp. 334–335.

5 Profits of the companies have grown from EEK 4 billion in 1999 to EEK 62 billion in 2006 and corporate tax revenues from EEK 1.6 billion in 1999 to EEK 3.5 billion in 2007 (Statistical Office of Estonia http://www.stat.ee/statistics).

6 Äriseadustik. – RT I 1995, 26–28, 355; 2008, 27, 177 (in Estonian). English translation available at http://www.just.ee/23295 (21.07.2008).

7 P. Reiljan, K. Oja. Valitsuse otsus meeldib ettevõtjale (Government's decision pleases businessmen). – Äripäev, 6.07.2007 (in Estonian).

3. Problems associated with the Estonian CIT system

Discussion of the problems that might emerge from the Estonian CIT system as effective from 1 January 2000 arose long before the system was implemented. Most of the anticipated problems did not, however, occur, and those that did take place were promptly eliminated. This section of the paper provides an overview of the expected and actual problems associated with the Estonian CIT system and the way in which they were solved.

Before the new Income Tax Act was passed, one of the concerns was that Estonia would be regarded as an offshore tax haven. The reason for this was a mistaken understanding of the Estonian CIT system, which, unfortunately, still prevails to some extent among tax law scholars. According to this misunderstanding, the CIT rate is considered to be 0% and the distribution tax is said to exist in Estonia, which is not correct, as one can see on the basis of the description above.

Regardless, the Estonian tax system does not have any of the features distinctive of tax havens. Firstly, corporate profits are always subject to CIT upon distribution, and the tax rate is 21% in 2008 (to be 20% for 2009, 19% for 2010, and 18% as of 2011). Moreover, there are no isolated so-called ‘ring fencing’ regimes, and domestic and foreign income are treated equally in Estonia. All companies are liable to pay taxes and to render their accounts, and penalties are imposed on companies in breach of these liabilities. Additionally, the Estonian tax authorities exchange information concerning Estonian residents and income derived in Estonia. Finally, the ITA stipulates a number of anti-avoidance rules, concerning, for example, transfer pricing, controlled foreign company (CFC) rules, and taxation of hidden profit distribution.[*8]

One more concern of those who mistakenly considered the Estonian CIT rate to be 0% was that Estonia might have problems with tax treaties, because the subject-to-tax condition is not fulfilled. Although the Estonian CIT rate was 26% in 2000 and, therefore, the subject-to-tax condition was met, problems arose with the double taxation treaty between Estonia and Latvia.[*9] As a result, a new tax treaty was made applicable in this connection from 1 January 2002.[*10] The main difference between the two treaties is that the newer treaty stipulates the limited right of the source state to tax dividends, interest, and royalties that were taxable only in the state of residence according to the previous treaty. Furthermore, the initial tax treaty enabled elimination of double taxation using both the credit and exemption method. The new tax treaty lays down only the credit method.

Originally, the ITA provided for tax-exemption of distributed profits if they were paid to resident companies with a view to eliminating double taxation. Profits distributed to non-residents were subject to tax. However, as the tax treaties contain a non-discrimination clause, the ITA was amended, and since 1 January 2003 the profits of companies have been taxed upon distribution without regard for the residence of the recipient. So, the problem of unequal treatment of residents and non-residents was solved, and currently the tax liability of a company distributing profits does not depend on the recipient.[*11]

In dealing with problems associated with the Estonian CIT system, another of its posited drawbacks is worth mentioning. This disadvantage is that dividends do not constitute taxable income of natural persons. As a result, dividends are not included in the aggregate amount of all types of taxable income from which personal allowances are deducted. Therefore, if a natural person does not have any income apart from dividends, he or she cannot use personal allowances and deductions.[*12] However, it seems to be reasonable that a person cannot deduct personal allowances if he or she does not have any taxable income and, consequently, tax liability does not arise.

If we compare the Estonian CIT system with CIT systems in other countries, it becomes clear that the Estonian system is advantageous for individual shareholders, as double taxation is not only mitigated but completely eliminated. There are two ways to provide full relief from economic double taxation: exempting dividends from taxation at shareholder level or at the company level.[*13] Estonia applies the former exemption type, taxing corporate profits at the level of the company. As a result of the exemption, individual shareholders cannot deduct personal allowances from the dividend☺ income, which is considered to be a disadvantage of the Estonian system. However, Estonia is not the only country where dividends are tax-exempt in the hands of the recipient. For example, Greece has applied a dividend exemption system since 1992. Under this system, corporate profits are taxed at the company level and dividends are not subject to further taxation at shareholder level. Therefore, natural persons cannot deduct personal allowances if they have only dividend income. [*14]

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8 L. Lehis (Note 3), pp. 16–17.

9 Eesti Vabariigi ja Läti Vabariigi vaheline tulu- ja kapitalimaksuga topeltmaksustamise vältimise ning maksudest hoidumise tõkestamise leping (Convention between the Government of the Republic of Estonia and the Government of the Republic of Latvia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income). – RT II 1993, 107 (in Estonian).

10 Convention between the Government of the Republic of Estonia and the Government of the Republic of Latvia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income. – RT II 2002, 33, 157.

11 For more elaborated information regarding the dispute over the tax treaty see A. Kurist, E. Uustalu (Note 4), pp. 344–345.

12 L. Lehis. Maksuõigus (Tax Law). Tallinn: Juura 2004, p. 256 (in Estonian).

13 P. J. Wattel, B. J. M. Terra. European Tax Law. 4th edition. Kluwer Deventer 2005, p. 263.

14 *Ibid*., p. 264.

Mistakenly, some tax scholars are of the opinion that Estonia applies the second option for elimination of double taxation — providing exemption at the level of the company as Greece did until 1992.*15 However, the Estonian system is different from the system that Greece used to apply and resembles more the current Greek system, wherein corporate profits are taxed at the company level and dividends are tax-exempt at shareholder level.

It is said that in the case of the system that was employed in Greece and is by mistake attributed to Estonia, it is essential to apply a high withholding tax on profit distributions, both for domestic purposes with a view to preventing tax evasion by domestic shareholders not declaring the dividend received on their tax return and for international purposes, because if the recipient is not subject to domestic tax, the country of the company would receive no tax revenue.*16 In Estonia, there is no need for a withholding tax on profit distributions at all, since profits are taxed only once, at the company level. Consequently, there can be no tax evasion by domestic shareholders, as they are not liable to pay tax on dividends. Regarding the international purposes, Estonia receives the tax revenue despite the fact that the recipient is not subject to domestic tax, because resident companies are subject to corporate income tax. Thus, it is inaccurate to compare the Estonian CIT system to the Greek system effective till 1992, as Estonia provides relief from economic double taxation, exempting dividends at shareholder level. Therefore, the Estonian CIT system is to some extent comparable to the Greek system currently in effect, wherein the imputed disadvantage of the Estonian system is also present — an individual shareholder cannot deduct personal allowances from dividend income.

Additionally, such deductions are not possible under systems where a final withholding tax is applicable (e.g., optional in Portugal and under certain conditions in Italy)*17, as well as in the case of half-rate systems. Under these systems, shareholders are in a more disadvantageous position than they would find in Estonia, as double taxation is not fully eliminated; it is only mitigated. For final withholding tax, corporate profits are taxed at the company level, and afterwards the tax is withheld from dividends and natural persons cannot deduct personal allowances from dividend income. In a half-rate system, corporate profits are taxed at the company level, income tax is withheld from dividends, and then dividends are taxed at half the marginal rate for other income and the tax withheld is credited against the final tax liability. Personal allowances are generally not deductible from dividend income.

Deductibility of personal allowances from dividend income is usually possible in half-base systems. However, it does not make these systems more advantageous, since they do not provide full relief from double taxation. In the case of half-base systems, corporate profits are taxed at the company level, then income tax is withheld from dividends, 50% or 60% of the dividend income is added to the aggregate income of the natural persons, personal allowances are deducted from the aggregate income, and the tax withheld is credited against the final tax liability. Despite personal allowances being taken into account, half-base systems eliminate double taxation only partially and, therefore, result in a less advantageous position of natural persons than the Estonian system provides.

The following table demonstrates the overall tax liabilities on dividends under different CIT systems.

	Estonian CIT system	**Final withholding tax**	**Half-base system**	**Half-rate system**
Corporate profit	100,000	100,000	100,000	100,000
CIT (20%)	20,000 (tax liability deferred till distribution)	20,000	20,000	20,000
Dividend	80,000	80,000	80,000	80,000
Withholding tax (10%)	–	8,000	8,000	8,000
Income subject to personal income tax	0	0	40,000	80,000
Deduction of annual personal allowance (30,000)	–	–	40,000–30,000 = 10,000	–
Personal income tax (20%)	–	–	2,000	8,000 (10% rate)
Credit for withholding tax	–	–	8,000	8,000
Remainder payable	–	–	0	0
Refunded	–	–	6,000	0
Shareholder's net income	80,000	72,000	78,000	72,000
Total tax levied	20,000	28,000	22,000	28,000

15 *Ibid*.

16 *Ibid*., pp. 263–264.

17 *Ibid*., p. 262.

The above table makes it obvious that the Estonian CIT system is generally more advantageous for the individual shareholder than other systems, despite the fact that personal allowances are not deductible from dividend income.

As follows from the aforesaid, Estonia has promptly eliminated all of the problems associated with the new CIT system, and the supposed drawbacks of the Estonian CIT system appear to be less disadvantageous, on balance, than what is seen in traditional systems.

4. Compatibility with EC law

It is a settled principle in the case law of the European Court of Justice that, although direct taxation falls within the competence of the Member States, they must nonetheless exercise that competence consistently with Community law.[*18] It is, therefore, important to assess whether the Estonian CIT system is compatible with EC law. Since some harmonisation measures have been taken in the field of direct taxation, it is, first of all, necessary to examine the consistency of the Estonian CIT system with the directives. The most relevant directive in the present case is undoubtedly the Parent–Subsidiary Directive. Consequently, the analysis of the conformity with this directive will follow.

4.1. The Parent–Subsidiary Directive contrasted against the Estonian CIT system

According to the preamble of the Parent–Subsidiary Directive, its objective is to create within the Community conditions analogous to those of an internal market. As tax provisions applicable to parent companies and subsidiaries of different Member States are generally less advantageous than those applicable to parent companies and subsidiaries in the same Member State, the directive seeks to eliminate such disadvantages. Therefore, Article 5 of the Parent–Subsidiary Directive compels Member States to exempt dividends and other profit distributions paid by a subsidiary established in one Member State to its parent company in another Member State from withholding tax, with a view to eliminating double taxation of such income in EU intra-group situations.

The term 'withholding tax' is not defined in the Parent–Subsidiary Directive. However, the ECJ has interpreted the notion of withholding tax within the meaning of Article 5 of the Parent–Subsidiary Directive in numerous cases. One of the first judgments was *Athinaiki*[*19], wherein the ECJ ruled that a withholding tax within the meaning of the Parent–Subsidiary Directive is, in essence, any tax payable in the event of distribution of profits by a subsidiary to its parent company.

Because of the deferral of taxation of profits as described above, two taxes are paid in Estonia at the moment of profit distribution:

1) a corporate income tax levied on the corporate profits, while the tax liability is deferred till the distribution of profits (in such a case, the taxpayer is an Estonian company distributing profits);
2) a withholding tax[*20] on dividends paid to non-residents whose shareholding in the company distributing dividends is less than 15% (the taxpayer is a non-resident company receiving the dividend).

It is clear that the latter is a withholding tax within the meaning of Article 5 of the Parent–Subsidiary Directive. However, as the amount is not withheld from dividends paid to parent companies, the directive is not applicable. The former tax is a corporate income tax within the meaning of Article 4 of the Parent–Subsidiary Directive. Logically, the same tax cannot constitute both corporate income tax within the meaning of Article 4 and withholding tax within the meaning of Article 5. It would also be bizarre if there were two withholding taxes from dividends. Moreover, it is commonly accepted in international tax law that a withholding tax is a tax on income imposed at source; i.e., a third party is charged with the task of deducting the tax from certain kinds of payments and remitting that amount to the government.[*21] Thus, in the case of a withholding tax, the company making the payment is obliged to remit the tax liability amount of the recipient of the payment to the tax authorities. Paying the Estonian corporate income tax, companies fulfil their own tax liability.

[18] For example Case C-446/03, *Marks & Spencer*. – ECR 2005, I-10837, paragraph 29; Case C-196/04, *Cadbury Schweppes and Cadbury Schweppes Overseas*. – ECR 2006, I-7995, paragraph 40; and Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*. – ECR 2006, I-11673, paragraph 36.

[19] C-294/99, *Athinaiki Zithopiia*, ECR 2001, I-6797.

[20] A withholding tax on dividends paid to non-residents will be abolished as of 1 January 2009.

[21] IBFD International Tax Glossary. 4th edition. IBFD Publications BV 2001.

However, the fact that taxation of corporate profits in Estonia is deferred until the moment of distribution was sufficient for the European Commission to consider the Estonian corporate income tax to be a withholding tax within the meaning of Article 5 of the Parent–Subsidiary Directive. The commission relied on the *Athinaiki* judgment cited above, although the Greek system contested in *Athinaiki* was different from the Estonian CIT system. As a result, when the Act of Accession*[22] of Estonia to the EU was concluded, the commission was of the opinion that Estonia had to change its CIT system. Therefore, Estonia was given a transition period, running until 2009, to eliminate inconsistencies with the Parent–Subsidiary Directive. The provision of the Act of Accession that concerns the transitional period is as follows:

> By way of derogation from Article 5 (1) of Directive 90/435/EEC, Estonia may, for as long as it charges income tax on distributed profits without taxing undistributed profits, and at the latest until 31 December 2008, continue to apply that tax to profits distributed by Estonian subsidiaries to their parent companies established in other Member States.*[23]

Consequently, according to the Act of Accession, Estonia is prohibited to tax distributed profits since 2009 only in cases where such taxation is not compatible with Article 5 (1) of the Parent–Subsidiary Directive. If there is no derogation from the directive, there is nothing to prevent Estonia from deferring the tax liability till the distribution of profits.

4.2. The compatibility of the Estonian CIT system with the Parent–Subsidiary Directive

In order to judge whether or not the Estonian tax system is consistent with the Parent−Subsidiary Directive, it is important to examine the tax system as a whole, not only as regards a single aspect. Moreover, instead of comparing formal features, it is essential to ascertain the reasons for imposing them and the aims they pursue. It is, therefore, necessary to analyse whether the tax system is in line with the overall objective of the directive.

As mentioned above, the purpose of the Parent–Subsidiary Directive is to eliminate double taxation as well as disadvantageous treatment of cross-border dividends as compared to domestic dividends. In the case of a traditional CIT system, corporate profits are generally taxed when they are earned. Additionally, the tax is withheld when the subsidiary distributes profits to its parent company. Thus, economic double taxation arises. If the parent company is a resident of another state, this state has a right to tax the worldwide profits of its resident, including dividends received from the non-resident subsidiary. In domestic situations, double taxation is usually avoided in accordance with the national legislation. In cross-border situations, there are tax treaties stipulating the methods of avoidance of double taxation. However, not all of the Member States have concluded tax treaties with each other. It was, therefore, necessary to take additional measures to avoid double taxation at Community level.

It is for the above-mentioned reasons that the Parent–Subsidiary Directive compels the Member State of a subsidiary to exempt the profits the subsidiary distributes to its parent company from withholding tax. Equally, the directive obliges the state of the parent company either to refrain from taxing dividends received from another Member State or, if it subjects such profits to tax, to entitle the parent company to a tax credit in relation to tax paid not only by the subsidiary but also by any lower-tier subsidiary. As a result, the profits are only taxed once.

As for the Estonian CIT system, the profits of the subsidiary are taxed for the first time when they are distributed (i.e., taxation of corporate profits is deferred) and there is no further withholding tax from dividends distributed to a parent company, irrespective of the domicile of the parent company. Thus, the Estonian CIT system does not give rise to either double taxation or disadvantageous treatment of cross-border dividends as compared to domestic dividends. Consequently, the Estonian CIT system conforms to the objective of the Parent−Subsidiary Directive.

Hence, as one can infer from the aforesaid, there is no derogation from Article 5 (1) of the Parent–Subsidiary Directive in the case of the Estonian CIT system. The prohibition of withholding tax from dividends paid by a subsidiary to its parent company as stipulated in Article 5 (1) aims at avoiding double taxation. The Estonian corporate income tax is the only tax due on the subsidiary's profits; thus, it does not give rise to double taxation of distributed profits. The mere fact that the tax liability arises when the profits are distributed is not sufficient for considering the tax to be a withholding tax. Besides, if the taxpayer is a subsidiary and the corporate income tax levied on the subsidiary's profits constitutes the first taxation of such profits, this corporate

[22] Act of Accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia (OJ 236, 23.09.2003).

[23] See Annex VI, chapter 7, section 2 of the Act of Accession.

income tax can in no way be regarded as a withholding tax. This statement is supported by recent judgments of the ECJ, which will be analysed in the following section.

4.3. The Estonian CIT system in the light of ECJ cases

The European Court of Justice has interpreted the term 'withholding tax' within the meaning of Article 5 (1) of the Parent–Subsidiary Directive in a number of cases. The most important among these are *Athinaiki*, cited above, and *FII Group Litigation*.[*24] Additionally, the ECJ assessed the scope of the Parent–Subsidiary Directive in the recent cases *Oy AA*[*25] and *Burda GmbH*.[*26] Below is examination of these ECJ judgments.

4.3.1. Case C-294/99, *Athinaiki*

Athinaiki provided the rationale for the commission's opinion that the Estonian corporate income tax could constitute a withholding tax within the meaning of Article 5 (1) of the Parent–Subsidiary Directive. In order to determine how the commission has drawn such a conclusion from this case and whether or not it is reasoned well, scrutiny of the judgment follows.

The *Athinaiki* case concerned a dispute over taxation of profits distributed by a Greek subsidiary to its parent company situated in the Netherlands. According to the Greek CIT system contested in *Athinaiki*, the profits were taxed when earned; however, certain income was tax-exempt or subject to special taxation entailing extinction of tax liability. When a subsidiary distributed profits to its parent company and these profits included income that was tax-exempt or subject to special taxation, such income was taken into account in determination of the taxable profits of the subsidiary.

In assessing whether the Greek legislation is compatible with the Parent–Subsidiary Directive, the ECJ highlighted two factors that in its opinion were distinctive of a withholding tax:

1) the chargeable event for the taxation at issue was the payment of dividends;
2) the amount of tax was directly related to the amount of the distribution.[*27]

Additionally, decisive seems to be the fact that the increase in the basic taxable amount generated by the distribution of profits could not be offset by the subsidiary using negative income from previous tax years, contrary to the fiscal principle enabling losses to be carried forward that was nevertheless laid down in Greek law.[*28] Therefore, the Greek tax disputed in the *Athinaiki* case could not be regarded as a corporate income tax, because the Greek legislation allowed offsetting losses from previous years for corporate income tax purposes. Conversely, there was no possibility of offsetting losses from the taxable amount generated by the distribution of profits. As a result, the ECJ considered the contested tax to be a withholding tax.

In order to determine the applicability of the *Athinaiki* judgment to the Estonian CIT system, it is necessary to analyse whether the Greek and Estonian systems are comparable. Indeed, the chargeable event for the Estonian corporate income tax is the distribution of profits and the amount of tax payable is in certain cases related to the amount of the distribution.[*29] However, if the Estonian subsidiary has received dividends, it can apply either the exemption or credit method, depending on the size of the shareholding in the company distributing dividends. The credit method is also applicable in respect of interest and royalties received, if they meet certain conditions. As a result of application of the exemption or credit method, the taxable profit distributions or the tax on distributed profits is reduced. Consequently, the amount of tax payable is not related to the distribution's amount if the subsidiary distributing profits has received dividends, interest, or royalties that meet certain conditions and have already been taxed.

That the Estonian subsidiary can deduct from the corporate income tax due on distributed profits the tax withheld from dividends, interest, or royalties received by the subsidiary is convincing evidence that the Estonian corporate income tax does not constitute a withholding tax. Otherwise, it would be quite unusual if it were possible to deduct the tax withheld from dividends, interest, or royalties received by the Estonian subsidiary from the tax withheld from dividends paid by this subsidiary.

One further crucial difference is that in Greece there was a corporate income tax and, additionally, tax on distributed profits in certain cases. In Estonia there is only corporate income tax, without any further distribution taxes.

24 Case C-446/04, *Test Claimants in the FII Group Litigation*. – ECR 2006, I-11753.

25 Case C-231/05, *Oy AA*.

26 Case C-284/06, *Burda GmbH*.

27 See paragraph 28 of the *Athinaiki* judgment.

28 See paragraph 29 of the *Athinaiki* judgment.

29 See chapter "Changes in the Estonian CIT System 2009" below about the amendments which will basically extinguish these aspects of the Estonian CIT system in order to highlight the compatibility with the Parent–Subsidiary Directive.

Moreover, the Greek legislation stipulated the right to carry forward losses from previous years, but only in cases of corporate income tax and not for tax due on distributed profits. As the rules of imposing of these two taxes differed, the tax on distributed profits could not constitute a corporate income tax. Contrarily, in Estonia, by virtue of deferral of tax liability until distribution of profits, there is no need for special rules regulating loss carry-forward. Specifically, the Estonian Commercial Code provides that profits cannot be distributed if the company has losses from previous years. As a result, tax liability cannot arise if the company has a negative income from previous years. Consequently, the Estonian CIT system is not comparable to the Greek one.

The issue of carrying forward loss seems to have ultimately contributed to the ECJ's final decision to a large extent. If the Greek legislation had avoided the situation where tax liability arises despite the existence of losses from previous tax years, the ECJ would most probably have come to the opposite conclusion. Therefore, account should be taken of the differences between the Greek and Estonian system before conclusions are drawn about the Estonian corporate income tax on the basis of the judgment dealing with the Greek CIT system.

4.3.2. Case C-446/04, *FII Group Litigation*

In the *Athinaiki* judgment, examined above, the ECJ diverged from the meaning of the term 'withholding tax' that was commonly accepted in international tax law. Generally, a withholding tax used to be viewed as a tax withheld and transferred to the tax authorities by the payer while the actual taxpayer is the beneficiary of the payment; thereafter, the tax withheld is credited against the recipient's final tax liability when the tax return is filed (with the exception of the final withholding tax). In a number of judgments[*30] defining the concept of a withholding tax within the meaning of Article 5 (1) of the Parent–Subsidiary Directive, the ECJ nonetheless returned to this common interpretation of a withholding tax. Below, the meaning of a withholding tax in the light of these judgments is analysed on the basis of the ultimate case *FII Group Litigation*.

In the *FII Group Litigation* judgment, the ECJ has set forth the conditions that should be met in order for a tax to be considered a withholding tax. The ECJ held that it is a matter of established case law that a withholding tax is any tax on income received in the state in which dividends are distributed where

1) the chargeable event for the tax is the payment of dividends or of any other income from shares,
2) the taxable amount is the income from those shares, and
3) the taxable person is the holder of the shares.[*31]

From the Estonian perspective, the most significant is the third condition, that the taxable person shall be the recipient of the dividends. Under the Estonian CIT system, the taxpayer is the Estonian subsidiary distributing profits to the parent company and the latter is not liable for paying income tax on dividends received.

The definition of a withholding tax in the *FII Group Litigation* case is followed by the reference to, inter alia, the *Athinaiki* judgment, wherein the ECJ has interpreted the term 'withholding tax' somewhat differently. One can, therefore, infer that the ECJ has considered all of the previous judgments where the term 'withholding tax' within the meaning of the Parent–Subsidiary Directive was interpreted and has drawn a general conclusion as to how the concept of withholding tax shall be defined henceforth. According to this definition, the Estonian corporate income tax is not a withholding tax, as the condition that the taxpayer shall be the recipient of the dividend is not fulfilled.

4.3.3. Case C-231/05, *Oy* AA

In addition to the cases in which the term 'withholding tax' is interpreted, there is an ECJ judgment wherein an attempt is made to ascertain the scope of the Parent–Subsidiary Directive. Below is the conclusion of the ECJ in the *Oy AA* judgment and assessment of its meaning for Estonia.

In the *Oy AA* case, the ECJ held that Directive 90/435 does not constitute the first taxation of income arising from a business activity of a subsidiary. Thus, the directive could not be a basis for supplying an answer to the question referred to the court.[*32]

Having explicitly ruled that the Parent–Subsidiary Directive does not regulate the first taxation of a subsidiary's profits, the ECJ has eliminated all doubts concerning the compatibility of the Estonian CIT system with the directive. The Estonian corporate income tax constitutes the first taxation of the subsidiary's profits, despite being levied only when the profits are distributed. No other tax is levied on the subsidiary's profits before the corporate income tax. Consequently, the Estonian corporate income tax cannot be in breach of Article 5 (1) of the Parent–Subsidiary Directive.

30 Case C-375/98, *Epson Europe*. – ECR 2000, I-4243; Case C-58/01, *Océ Van der Grinten*. – ECR 2003, I-9809; Case C-446/04, *Test Claimants in the FII Group Litigation*. – ECR 2006, I-11753.

31 See paragraph 108 of the *FII Group Litigation* judgment.

32 See paragraph 27 of the *Oy AA* judgment.

4.3.4. Case C-284/06, *Burda GmbH*

Finally, on 26 June 2008, a decision was issued that clarified that in interpretation of the term 'withholding tax' all three conditions mentioned above, including the requirement that the taxable person be the holder of the shares — as stated in previous case law — must be met[*33]. Consequently, the court concluded that "a provision of national law which, in relation to cases where profits are distributed by a subsidiary to its parent company, provides for the taxation of income and asset increases of the subsidiary which would not have been taxed if they had remained with subsidiary and had not been distributed to parent company does not constitute withholding tax within the meaning of Article 5(1) of Council Directive 90/435".[*34] By stating this, the court took an opposite view to what had been concluded in the *Athinaiki* judgment[*35] and thus indirectly also confirmed the compatibility of the Estonian income tax system with the directive.

5. Changes in the Estonian CIT system from 2009

Despite the evidence that in the case of the Estonian CIT system, there is no derogation from Article 5 (1) of the Parent–Subsidiary Directive, but before ECJ case on Burda was issued, Estonia took action in order to minimise the possible risks that the Estonian corporate income tax would still be deemed to be a withholding tax. Therefore, on 26 March 2008, Estonia adopted amendments to the income tax law[*36] to change the corporate income tax system as of 1 January 2009 in order to highlight the compatibility with the Parent–Subsidiary Directive.

The spring 2008 amendments were meant to retain the distinctive feature of the Estonian corporate tax system — deferral of corporate income tax liability until the distribution of profits. The amendments provided for a change of the taxable period from calendar month to calendar year where the filing of the tax return and tax payment would have become due within six months after the end of the tax year. Additionally, the tax base would have been changed to comprise corporate profits distributed in the tax period adjusted by taxable gifts, donations, representation costs, expenses and payments unrelated to business. Furthermore, the taxable base would have been expanded by liquidation proceeds and payments made in the case of a reduction in the share capital of the company or redemption or return of shares in the amount by which they exceed monetary and non-monetary contributions to the equity of the company.

The annual corporate tax liability would have been complemented by advance payments due twice per tax period, with the amount of the instalments determined on the basis of the average taxable amount for the last three tax years and the tax rate currently in effect. When the tax return was filed and the corporate income tax due calculated, the advance payments would have been offset against the final tax liability. As a result of the amendments, none of the features distinctive of a withholding tax pursuant to the ECJ case law would have been present in the Estonian CIT system. The chargeable event would not have been the payment of dividends, and the taxable amount would have not been directly related to the amount of the distribution. Moreover, companies would have been liable to make advance payments of corporate income tax that is credited against the final tax liability on the joint tax base calculated in the tax return once a year. It is clear that there can be no advance payment of a withholding tax, especially if the instalments are determined on the basis of previous tax years instead of the payments made in the current tax year. Therefore, the Estonian corporate income tax should have not been constituting a withholding tax within the meaning of the Parent–Subsidiary Directive.

However, after the ECJ case on *Burda* was issued, it became clear that there is actually no need to change the Estonian corporate tax system as of 1 January 2009 to bring it in line with the Parent–Subsidiary Directive. Therefore, on 20 November 2008, new corporate tax law amendments[*37] were adopted by the Parliament that abolished the amendments adopted earlier in spring. Thus corporate tax period remained a calendar month and no advance corporate tax payments were introduced.

In fact, the autumn law abolished as of 1 January 2009 the only real withholding tax that existed upon dividend payments, namely on those made to non-resident corporate portfolio shareholders. This amendment, however, was not related to the compatibility of the tax system with the Parent–Subsidiary directive, but was based on Commission's infringement procedure of 31.01.2008[*38] where the issue was raised whether the Estonian tax withheld from foreign pension funds is compatible with fundamental freedoms provided by the EC Treaty, when no similar tax is withheld on payments made to domestic pension funds.

33 See paragraphs 61–62 of the *Burda* judgment.

34 See paragraph 64 of the *Burda* judgment.

35 Compare paragraph 64 of the *Burda* judgment and paragraph 55 of the *Athinaiki* judgment.

36 Tulumaksuseadus. – RT I 2008, 17, 119 (in Estonian).

37 Available at www.riigikogu.ee (draft 352 SE III). Law has not been published in State Gazette yet.

38 European Commission's press release IP/08/143.

6. The Estonian CIT system — only for Estonia or a good idea for others?

Estonia is the first country to establish a CIT system under which taxation of corporate profits is deferred until their distribution. Having created such a unique system, Estonia has attracted the attention of tax scholars all over the world. Moldova even decided to implement a CIT system similar to the Estonian one as of 1 January 2008. Furthermore, the German foundation *Humanistische Stiftung* (the Humanist Foundation) has conducted an essay competition regarding deferred taxation of corporate profits.

6.1. The CIT Reform of 2008 in Moldova

Moldova decided to make its CIT system similar to the Estonian system as of 1 January 2008; however, because of the inaccurate understanding of the substance of the Estonian CIT system, the new Moldovan system turned out to be different from the Estonian one.[*39]

As a result of the CIT reform in Moldova, from 1 January 2008, the corporate income tax rate is reduced to zero and dividends distributed to resident corporate shareholders are subject to neither corporate income tax nor withholding tax. Dividends distributed to resident individuals are taxable at shareholder level at the general rates. As for dividends paid to non-resident shareholders, a final withholding tax is imposed on the gross amount at the rate of 15%, unless a tax treaty provides otherwise.[*40]

Thus, corporate profits of Moldovan companies are not subject to tax at all from 1 January 2008, whereas in Estonia the tax liability of the companies is deferred until the distribution of profits. Being exempted from CIT, the Moldovan companies still have to withhold income tax at a rate of 15% from certain payments made to natural persons. Such a withholding tax constitutes a tax liability of the natural person receiving the payment, not of the company making the payment.[*41]

It follows from the above that the only similarity between the Estonian and Moldovan CIT systems is that the retained profits of the companies are tax-exempt. However, in Estonia, corporate profits are subject to corporate income tax when they are distributed. Additionally, expenses that usually are not deductible under traditional systems are taxable in Estonia. Contrarily, corporate income tax has been abolished completely in Moldova.

Absence of corporate income tax may result in some of the problems that were discussed when Estonia decided to change its CIT system. For instance, problems may arise in relation to tax treaties, because the subject-to-tax condition is not fulfilled if there is no corporate income tax and double taxation does not take place. Consequently, contracting states do not have to refrain from taxation, as there is no need to avoid double taxation. Hence, Moldova would appear to have abolished corporate income tax in favour of it being levied by other states. Conversely, companies would not benefit from the new tax system. Moreover, some states might apply CFC rules in respect of Moldova.

These problems did not arise in Estonia, because corporate income tax was not abolished; the tax liability was simply deferred. However, there is a risk that such problems may be seen in Moldova, as corporate income tax has actually been abolished. Accordingly, it might be reasonable for Moldova to amend its system in order to make it more similar to the Estonian CIT system, with a view to avoiding the above-mentioned problems.

6.2. The essay competition in Germany concerning deferred taxation

Humanistische Stiftung, whose main objective is to promote modernisation of German income tax laws, has arranged an essay competition on the following topics:

1. When deferred taxation is applied to corporate profits, do the basic liberties set forth in the EC and EU treaties prohibit member states of the European Union from securing the taxation of income earned domestically?
2. Can deferred taxation provide a uniform measure for assessing the taxation of corporate profits in the European Union?

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39 А. Канду, С. Чебан. Налоговая конференция: вопросы для обсуждения. – Экономическое обозрение, 19.10.2007, No. 38, p. 18. E. Banaru. Moldova kak novoe privlekatelnoe napravlenie na investitsionnoi karte Evropii. – BusinessClass 2008/1, pp. 64–67.

40 Global Tax Surveys, Chapter on Moldova. Available at www.ibfd.org.

41 А. Канду, С. Чебан (Note 39), p. 18.

The current German tax system is considered to be one of the reasons for the ailing condition of the German economy, and *Humanistische Stiftung* finds it necessary therefore to change the system. One of the alternatives to the current German tax system is a system of so-called deferred taxation. There are a number of advantages to deferred taxation, which *Humanistische Stiftung* has brought out.

Firstly, whereas traditional systems obstruct growth and employment, deferred taxation facilitates innovativeness and promotes development and employment. Moreover, deferred taxation does not lead to a shifting of the tax burden from income derived from business to income from labour. In addition, it does not result in definitive shortfalls in tax revenue; it gives rise to tax deferrals without actual loss of tax revenue. In addition to fostering growth, employment, and positive influence on equity capital in companies, deferred corporate taxation provides equal treatment of all forms of business entities and offers great simplicity. Hence, *Humanistische Stiftung* has concluded that it seems to be feasible to apply distribution of profits as a starting point for taxation in all Member States.[*42]

7. Conclusions

As has been demonstrated, while being different from traditional systems on account of its deferral of taxation until profit distribution, the Estonian CIT system maintains all of the fundamental elements of a traditional CIT system and at the same time minimises the number of technicalities essential in a CIT system. As a result, the Estonian CIT system is simple and transparent, fosters investments, and mitigates companies' motivation to hide profits. By comparison with traditional systems, one can observe that the Estonian CIT system is easier to comply with for both the taxpayer and those in tax administration.

It is fundamental, however, not to confuse the tax deferral provided under the Estonian CIT system with the tax-exemption of profits at corporate level that is mistakenly attributed to the Estonian system. The tax liability is merely deferred in Estonia, and distributed profits are tax-exempt at the shareholder level, not at the level of the company distributing profits.

Additionally, it should be stressed that, since the Estonian CIT system is in line with the objective of the Parent–Subsidiary Directive, the mere fact that taxation is related to the distribution of profits does not necessarily mean that corporate income tax constitutes a withholding tax within the meaning of the language of the directive. Therefore, instead of drawing conclusions on the basis of formality, one should examine the substance of the Estonian CIT system. Such an assessment clearly shows that there is no breach of the Parent−Subsidiary Directive and that, being a primary tax levied on corporate profits, the Estonian tax constitutes a corporate income tax, not a withholding tax. This viewpoint is supported by the recent judgments of the ECJ.

Moreover, changes of the Estonian CIT system for 2009 highlight the fact that the system is compatible with the Parent–Subsidiary Directive. As a result of these amendments, the chargeable event will no longer be the payment of dividends as such, and the taxable amount will not be directly related to the amount of the distribution. Additionally, the new liability to make advance payments of corporate income tax on the basis of the average taxable amount for the last three tax years, which will be credited against the ultimate tax liability, will make it more clear that the Estonian corporate income tax is not a withholding tax, since there can be no advance payment of a withholding tax.

Finally, the interest shown by tax scholars in the Estonian CIT system and the experience of Moldova and Germany in relation to the system of deferred taxation show that other states could benefit as well from the implementation of such a CIT system. Furthermore, as the German foundation *Humanistische Stiftung* has pointed out, deferred taxation seems to be feasible for providing a uniform means of assessing taxation of corporate profits in the European Union.

[42] Available at http://www.humanistische-stiftung.de/auslobung-2/de/.