# TAXATION:

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## The Role of Estonian Corporate Tax System in Attracting Foreign Direct Investment and Estonian National Competitiveness in the Region

The American Chamber of Commerce Estonia (AmCham Estonia) believes that Estonia needs to address several taxation issues outlined below to help maintain a competitive position in the region and attract more foreign direct investment into the country. Since the Estonian government's strategy is oriented towards the creation of additional high-value jobs in Estonia and bringing "bright minds" into the country to add value to the economy, AmCham Estonia believes that the way to transform Estonia from a low-cost labor and contract-manufacturing country into an innovative and creative science and technology-based economy, would be to enhance a few nuances in the current Taxation system, including R&D incentives, labor taxes, and stock award program.

**Taxation Issues Identified by member-companies and investors:**

- Employment Taxation/Social Taxes/Sick Leave Compensation & Burden
    - No possibility to separate pension and health insurance components of the social tax
    - Lacking voluntary social insurance for non-working family members
    - Sickness pay regulations disfavour employees to a considerable degree
    - High labor taxes affect the wage cost competitiveness in low value-added sectors, as the deferred taxation on reinvested profits does not provide a substantial relief to the employer
    - Net wages of lower-paid employees are under pressure due to the low tax free threshold

- Stock Award Program with Fringe Benefit Tax for Employer
    - Rigid and outdated fringe benefit taxation
    - Estonian Income Tax Act clearly mentions only the taxation of stock options, but at the same time does not define explicitly the concept of stock option

- As a tax exemption, issuing a stock option is not considered a fringe benefit if three years pass after issue of the option to the employee and before exercising it. If the employee should decide to sell the option within three years, the fringe benefit tax is paid by the employer instead of the employee. The latter is still taxed on capital gains from the sale of option shares
- the high tax cost of the benefit for the employer and zero to the employee
- the taxable fringe benefits received by a resident employee are in general not included in the taxable income of the employee for Estonian tax purposes
- the absence of clear guidelines from the local tax authorities and/or relevant court practice regarding the stock award/stock option programs

- Absence of R&D credits/ Incentives
  - No R&D tax incentives
  - High employment taxes in Estonia
  - Estonian corporate tax system benefits profitable companies who can turn their profit into additional investments and thereby boost growth
  - R&D companies are usually not profitable in the development phase, so the corporate tax system does not provide any support to such companies
  - R&D companies' tax burden (from employment taxes) in comparison to the value of their assets of profits is significantly higher than that of low value production companies, because R&D sector's salary costs are often multiple times higher than those in the production sector

- Necessity to Cap Social Tax
  - Delay in actual application of cap and high threshold, also the intention to impose the cap only on pension share
  - Setting the cap will foster the recruitment of educated and high-skilled employees from abroad and encourage foreign investors to invest into the higher added-value segments and respective jobs
  - Enables to reduce emigration risk of high-skilled specialists
  - Help to fight more efficiently against tax optimization using companies and dividends distributions instead of paying salaries

- Taxation of Capital Gains
  - Capital gains from sale of shares taxable, as opposed to neighbouring countries

- No participation in respect to capital gains from sale of shares of a subsidiary. Such participation exemption may be found for example in Finland, Sweden, Lithuania, Latvia (since 2013), Cyprus, and the Netherlands etc.
- It's a huge disadvantage compared to the neighboring countries, where the shares of subsidiary may be sold without any tax at the level on the parent company
- Participation exemption will give Estonia an additional competitive advantage and a signal to potential investors that regional holding companies with regional managerial jobs are welcome to Estonia
- without this exemption foreign companies will be rather reluctant to establish to Estonia their regional headquarters, i.e. which as a result will mean less high skilled jobs and decision makers for Estonian economy

- Alternatives to preserve state tax revenue
  - Consider taxing corporate income on an annual basis, regardless of distribution
  - In order to preserve Estonia's competitiveness as a jurisdiction with a favorable corporate income taxation regime, the tax rate should be kept low, double taxation avoided and tax administration kept very simple

- High energy taxes distort international competitiveness and limit investments
  - Estonia is narrowly implemented obligatory tax exemptions for energy excise duty and applies flat tax rate on renewable charge, not considering the principles of European Union directive and rules of European Commission insisting the importance to apply the lowest possible tax rates to ensure the competitiveness of energy intensive companies
  - Estonia has chosen non-competitive tax burdens having adverse impact particularly to exporting, large and energy intensive companies. As result of this the large and energy intensive companies will bear unreasonable tax load and pay millions of euros more for energy taxes compared to many European countries.
  - The competition suffers particularly in comparison with Finland and Sweden which amongst many other factors compete in the sectors adding value for the national resources like wood, etc
  - Setting the caps will foster the growth of existing companies and would deliver additional foreign investments into industrial sector in Estonia

**Corresponding Recommendations:**

- Employment Taxation/Social Taxes/Sick Leave Compensation & Burden:
    - o Keep reducing personal income tax rate, or at least to increase the income-tax-free minimum threshold in order to cut labor tax costs on below average wages in labor-intensive sectors.
    - o Consider to divide the social security tax burden between the employees and the employers
    - o Consider the health insurance (13%) to be voluntary in certain circumstances (e.g. in situation where the health insurance is covered by private insurance system).
    - o To ensure the sustainability of the health care system, the costs made for the benefit of the employees' health should be exempt from fringe benefit tax and voluntary sickness, life and accident insurance should be introduced to which the employer contributions would be tax exempted to a certain threshold.

- Stock Award Program with Fringe Benefit Tax for Employer
    - o Promote among the employers the grant stock awards and stock options instead of simple monetary payments to the employees
    - o Encourage the government to review different compensation mechanisms and adjust Estonian taxation legislation to cover this present situation
    - o Consider allowing the fringe benefit tax exemption to different compensation mechanisms (e.g. shorten the tax exemption period from present three years to one year
    - o Offering different kind of solutions how to postpone or even exempt stock award and/or stock options from the fringe benefit taxes (considering a setting a cap to the fringe benefit tax regarding the stock award and/or stock options; offering registration of the stock awards program to shorten the time period where it´s being taxed and for avoidance of the misuse of the program).

- Absence of R&D Credits/ Incentives
    - o Capping social tax of temporarily employed foreign R&D experts
    - o The proposal is specifically oriented towards temporary foreign experts, because the cost of capping the social tax for such people would be lower as they would not benefit from the Estonian state pensions and other social security guarantees as much as local people

  - We would recommend reducing the health insurance part of the social tax from 13% to 3%.
  - Lowering of personal income tax of temporarily employed foreign R&D experts
  - In conjunction or separately from the capping of social tax, we would propose lowering the personal income tax rate of temporarily employed foreign R&D experts from 21% to 10%
  - Exempting profits from intellectual property licensing (e.g. patents) from corporate income tax or lowering the applicable tax rate (e.g. to 5%)
  - For those companies, that will manage to effectively develop innovative products and protect those with patents we would propose exempting the profits from the utilization of such patents or taxing those profits with 5% corporate income tax, instead of standard 21%

- Necessity to Cap Social Tax
  - Applying an upper ceiling (cap) for social tax as soon as possible is a must
  - The tax legislation should be amended in such way, that starting from a certain level – according to our assessment, the suitable level starts from 2xmonthly gross average salaries – neither the employer nor employee would have to pay social tax from gross salary (labour taxes will be fully paid up to this amount)
  - All social benefits should be capped with the same limit to decrease the governmental expenses
  - Consider reducing the cap threshold, as well as its extension, in addition to the health insurance share of the social tax

- Taxation of Capital Gains
  - Allow participation exemption in respect to capital gains from sale of shares of a subsidiary

- Corporate income tax on equity
  - Instate a corporate income tax on equity that would be deductible from dividend distribution tax
  - The idea is to raise tax revenue, encourage businesses to use their equity effectively and protect minority shareholders' interests
  - Tax rate below 5%
  - Keep tax administration very simple and avoid variations and exemptions

- High energy tariffs and taxes
  - Implement the tax exemptions and ceilings for energy excise duty considering the principles of European Union directive (2003) insisting on the importance to apply the lowest possible tax rates to ensure the competitiveness of energy intensive companies
  - Implement tax ceilings for renewable charge considering the 2014 State Aid Rules of European Commission which highlights that the charges levied for the funding of renewable energy support make up an increasing proportion of the energy bill for industry, which constitutes a very high burden for some energy intensive companies, in particular those exposed to strong international competition