



MERGERS AND ACQUISITIONS

Estonia

Taxation of Cross-Border
Mergers and Acquisitions

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TAX

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Introduction

Cross-border mergers and acquisitions (M&A) are becoming more common in Estonia. After the regaining of independence in the early 1990s until mid 2000s there was substantial foreign direct investment into Estonia, mostly from Scandinavian and Western European countries. The global credit crunch of late the 2000s greatly reduced M&A activity, but it is expected that in the early 2010s M&A activity will rise again, because of lower prices, higher potential, stability and the business culture as well the growing reputation of Estonia as a state and an investment location.

Recent Developments

As noted earlier the volume of cross-border M&A transactions has fallen greatly since 2007, both in terms of the number and the size of transactions, but the global economic recession has also created new drivers for takeovers, such as the inclination of producers to acquire indebted distributors.

Asset Purchase or Share Purchase

Acquisitions in Estonia are usually effected by asset or share purchase. Both have their advantages and disadvantages, depending on the composition of the assets and obligations in the target business. Due to the original Estonian corporate taxation system which stipulated that profits retained in the company are not taxed until they are distributed to shareholders, tax instruments such as tax depreciation, tax loss carry-forward, and deferrals do not exist in Estonia, and there are no tax differences between asset or share deals. That said, however, most transactions have been share deals.

Purchase of Assets

The purchase of assets can be conducted either as purchase of an enterprise, or a part of it, or a purchase of individual assets.

The transfer of an enterprise is regulated by the Law of Obligations Act, but the terms and conditions of such transactions also fall within the regulatory scope of several other laws relating to the composition of the assets and obligations, etc.

The legal definition of an enterprise is given in Article 180 Section 2 of the Obligations Act: an enterprise comprises the things (assets), rights, and obligations relating to and in the service of the management of the enterprise, including contracts relating to the enterprise.

Article 182 of the Obligations Act regulates the transfer of things, rights, and contracts. The basic legal principles are:

- Things belonging to an enterprise: provisions relating to the transfer of things are applicable. This means requirements regarding the form, transfer of possession, registration, and filing, among others, of a thing should be followed.
- Rights belonging to an enterprise: provisions covering the transfer of rights are applicable. This means that mandatory requirements regarding the form, transfer of possession, registration, and filing, among others, of a right should be followed.
- Contracts belonging to an enterprise: provisions regulating transfer of contracts are applicable.

Article 179 of the Obligations Act stipulates that the consent of the other party to the contract is required on transfer of contractual rights and obligations to a third party, so it is advisable to ask for the written consent of the contractual partners.

In accordance with the Estonian Employment Contract Act, employment contracts with the employees shall transfer to the purchaser of the enterprise. It should be noted that the terms and conditions of the employment contracts may not be amended without the written agreement of the employee, and the employee is expected to retain all of his/her rights under the existing employment contract. In this respect, Estonia has followed directives 77/187/EEC and its amendments and updates.

Article 182, Section 2 of the Obligations Act further stipulates that by taking over the things and rights belonging to an enterprise, the purchaser also takes over all of the transferor's obligations that relate to the enterprise, unless otherwise provided by law. Contracts derogating from this provision have no effect against third parties. Such contracts apply to creditors who have

consented to the contracts in writing. This provision includes all the obligations that the enterprise may have, including, but not confined to tax obligations and previous deals.

According to Article 183 of the Obligations Act, the transferor and the purchaser of an enterprise shall be jointly liable to the creditor for obligations which have arisen before the transfer of the enterprise and which, by the time of the transfer, have fallen due or will fall due within five years after the transfer.

The only way for the purchaser of the enterprise to be relieved of the liability for the debts, obligations, or other responsibilities is to get a written confirmation from each and every creditor in which the creditor explicitly consents to a regulation of liability different from the regulation stipulated by law.

The transfer of an enterprise or a part of it under the Law of Obligations Act is not subject to value-added tax (VAT).

The purchase of individual items makes it possible for the buyer to eliminate the risk of liabilities of past periods. However, it may involve certain taxes and duties. For example, the sale of movable things in Estonia is generally subject to local 20 percent VAT, unless sold outside Estonia to a foreign VAT-liable person. Real estate transactions are generally exempt from VAT, but involve notary fees and stamp duties.

The purchase of the assets of an Estonian company is not subject to corporate income tax. When assets are acquired with no charge (in the form of a gift), the provider of the assets has to pay 21 percent (applicable rate in 2009) corporate income tax on the value of those assets, because the free transfer is regarded as a taxable gift. In the case of related parties, transfer pricing principles apply. If the acquirer sells these assets, the sale proceeds are deemed regular business income, so there is no immediate capital gains tax. Corporate income tax will be levied, however, when that income is distributed to shareholders.

Purchase Price

The purchase price has to be at arm's length if a transaction is made between related parties. Income from sales of shares or assets is considered regular business revenue taxable on distribution. Purchases of shares or assets are generally considered business-related costs, which means they are deductible for tax purposes.

Value-Added Tax (VAT)

The acquisition of company in Estonia by a share purchase is generally not subject to VAT. There is an option to charge VAT, but it is rarely exercised.

The acquisition of a company by an asset deal may be regarded as a non-taxable supply if the conditions established by the VAT Act are met. The asset deal has to be the transfer of an enterprise or a part of an enterprise within the meaning of the Obligations Act, and the enterprise or part thereof should be used for the purposes of taxable supply.

The transfer of individual assets (except for real estate) is generally regarded as a taxable supply and is, therefore, subject to Estonian VAT.

Transfer Taxes

Stamp duty is levied only on instruments transferring ownership of certain assets such as immovables and some registered movables. The stamp duty is also applicable when transferring part of the enterprise.

Purchase of Shares

A purchase of shares in an Estonian company is tax neutral. There are no significant stamp duties or other levies. Under certain circumstances the new shareholder must open a securities account in a bank, which is usually simply a formality.

Tax Indemnities and Warranties

Indemnities and warranties are a regular practice in Estonian M&A transactions and are usually related to transfer pricing.

Pre-Sale Dividend

Pre-sale dividends are taxable at the 21 percent corporate income tax (in 2009).

Transfer Taxes

There is no stamp duty on a transfer of shares, but a transfer of a holding in a private limited company (osaühing, OÜ) must be notarized and, therefore, the transaction is subject to notary fees.

Choice of Acquisition Vehicle

Local Holding Company

Holding companies are used if several companies are acquired in Estonia, but since the tax liability on a profit distribution generally falls on the first level of distribution, there is no tax reason to establish a holding company in Estonia. However, for group treasuries or shared service centre purposes holding companies are

often used, and private investors use holding companies to avoid the immediate personal income tax consequences of sales of shares or assets.

Foreign Parent Company

The vast majority of large Estonian companies are owned by foreign parent companies, usually of Scandinavian or Western European origin.

Non-Resident Intermediate Holding Company

Non-Resident intermediate holding companies are advisable for investments to and from countries with which Estonia does not have tax treaties. For example, Dutch BVs are sometimes used for investments to or from Russia.

Local Branch

Under the Estonian tax system, in some circumstances it is not feasible to have a branch office in Estonia for tax reasons. If the country of origin applies the credit method for double taxation avoidance of income from an Estonian permanent establishment, for example, the credit period may expire before the Estonian PE distributes profits and pays tax in Estonia, in which case double tax avoidance may be problematic or even impossible.

Choice of Acquisition Funding

Debt

Introducing debt to the acquired Estonian company generally helps to avoid dividend taxation, because profits can be expatriated via debt repayment. There are no thin-capitalization rules in Estonia, but, interest has to be at arm's length.

Deductibility of Interest

Interest expenses are considered business-related costs and thus deductible for tax purposes.

Withholding Tax on Debt and Methods to Reduce or Eliminate

Withholding tax (WHT) applies on interest in excess of market (arms length) rates.

Equity

Contributions (monetary and non-monetary) to the equity of an Estonian company can be repaid to the shareholders with no tax consequences via reductions of share capital, share buy-backs or liquidation proceeds.

Hybrids

Interest can be paid on financial instruments. Additional value paid on equity instruments is usually classified as

dividend, and is therefore subject to 21-percent corporate income tax.

Other Considerations

Concerns of the Seller

Sellers usually prefer share deals, to avoid the liquidation of the company and to transfer potential risks from previous periods to the purchaser.

Company Law and Accounting

The two types of limited company usually chosen for business in Estonia are the public limited company (aktsiaselts, AS) and the private limited company (osaühing, OÜ). Generally, for a medium-sized enterprises it is easier to conduct business with a private limited company, but an enterprise with many shareholders that wishes to issue listed securities on the Exchange, has to form a public limited company.

The Commercial Code also permits a foreign company to undertake business activities in Estonia through a branch office (filiaal).

According to the Estonian Commercial Code, there are two methods of merger:

- The company being acquired may merge with the acquiring company and shall be deemed to be dissolved following the entry of the merger in the commercial register.
- Companies may also merge by establishing a new company. In this case, both merging companies shall be deemed dissolved following the entry of the merger in the Commercial Register.

The main legal effects of a merger entry in the commercial register are:

- the assets of the company acquired shall be transferred to the acquiring company; and
- the shareholders of the company being acquired shall become the shareholders of the acquiring company according to the proportions set out in the merger agreement.

On 15 December 2007 amendments to the Commercial Code incorporating the EU cross-border merger directive (2005/56/EU) in the Estonian legislation became effective. Regulation of cross-border mergers set forth in the Commercial Code is similar to but somewhat stricter than national merger regulation.

The Commercial Code sets out two de-merger methods: division by distribution, or by separation. The

main difference is that on separation, the company being divided continues to exist, while on distribution, the company being divided ceases to exist as the result of the division.

A transfer of assets and liabilities (an enterprise) is regulated by the Law of Obligations Act. The required documentation varies, depending on the composition of assets and liabilities.

By acquiring the things and rights, the transferee assumes all of the transferor's obligations relating to the enterprise, including obligations arising from employment contracts.

Transferor and transferee shall be jointly liable to the creditors for obligations which have arisen before the transaction and which, by the time of the transaction, have fallen due or shall fall due within five years after the transfer. Agreements derogating from the joint liability principle have no effect against third parties unless the third party has given prior written consent.

Since 1995 Estonian accounting principles have been based on IFRSs. The current Accounting Act has been in force since 2003, with some minor amendments in recent years to reflect corresponding changes in IFRSs. According to the Act, commercial undertakings can choose whether to prepare their annual financial statements according to Estonian Accounting Standards (RTJ) or IFRSs. Listed companies, credit institutions, and insurance companies are required to follow IFRSs.

Group Relief/Consolidation

The Estonian tax law considers each company of a group as a separate tax entity. Therefore, each company must prepare its own financial statements, and group consolidation for tax purposes is not possible. If one group company, for example, pays for some expenses of another group company and does not claim a refund, the payment could be taxed as a non-business expense at the first company, even though the transfer was necessary for the group.

Transfer Pricing

If the value of a transaction conducted between associated persons (including transactions carried out between a permanent establishment and its head office) differs from the value of similar transactions conducted between independent persons, the tax administrator may, when making an assessment of income tax, apply the value of transactions used by independent persons under similar conditions. From 1 January 2007, the transfer pricing regulation applied to transactions between related, resident companies in the

same way as it was to transactions carried out between related, non-residents or individuals.

In 2007, new wording in the Income Tax Act imposed on companies an obligation to document their transactions with associated parties.

Dual Residency

A company is considered to be Estonian tax-resident only if it is registered with the Commercial Register.

Comparison of Asset and Share Purchases

Advantages of Asset Purchases

- In the case of a purchase of individual things, no previous liabilities of the company will be transferred. On a transfer of an enterprise, however, the liabilities will be assumed by the purchaser as well.
- No VAT consequences on a transfer of an enterprise or a part of it within the meaning of the Obligations Act (both assets and liabilities).
- Part of a business can be acquired.
- More flexible financing possibilities.

Disadvantages of Asset Purchases

- A possible need to renegotiate supply and employment agreements, among others.
- An asset sale could be less attractive to the seller; therefore the price may be higher.
- Transfer taxes on transfers of real property and VAT on transfers of movables.

Advantages of Share Purchases

- The share sale is probably more favorable to the seller; therefore the price may be lower.
- The purchaser could benefit from existing supply and technology contracts, among others.
- No transfer duties on share transfers, except for minor notary fees and stamp duties on transfers of holdings in private limited companies (osaühing, OÜ).
- Not subject to VAT.

Disadvantages of Share Purchases

- Purchaser will be liable for all actual and contingent liabilities of the entity.

Withholding Tax Rate Chart

The rate information and footnotes contained in this table are from the 2009 IBFD/KPMG Global Corporate Tax Handbook.

Country	Dividends		Interest ¹ (%)	Royalties ² (%)
	Individuals, Companies ³ (%)	Qualifying Companies ⁴ (%)		
Armenia	15	5	10	10
Austria	15	5	10	5/10
Azerbaijan	10	5	10	10
Belarus	10	10	10	10
Belgium	15	5	10	5/10
Bulgaria	5	0 ⁵	0/5 ⁶	5
Canada	15	5	10	10
China (People's Rep.)	10	5	10	10
Croatia	15	5 ⁵	10	10
Czech Republic	15	5	10	10
Denmark	15	5	10	5/10
Finland	15	5	10	5/10
France	15	5 ⁵	0/10 ⁶	5/10
Georgia	15	5 ⁷	10	10
Germany	15	5	10	5/10
Greece	15	5	10	5/10
Hungary	15	5	10	5/10 ⁸
Iceland	15	5	10	5/10
Ireland	15	5	10	5/10
Italy	15	5 ⁵	10	5/10
Kazakhstan	15	5	10	15
Latvia	15	5	10	5/10
Lithuania	15	5 ⁹	10	10
Luxembourg ¹⁰	15	5	0/10 ¹¹	5/10
Malta	15	5	10	10
Moldova	10	10	10	10
Macedonia	5	0	5	5
Netherlands	15	5	0/10 ⁶	5/10
Norway	15	5	10	5/10
Poland	15	5	10	10
Portugal	10	10	10	10
Romania	10	10	10	10
Singapore	10	5	10	7.5
Slovak Republic	10	10	10	10
Slovenia	15	5	10	10
Spain	15	5	0/10 ⁶	5/10
Sweden	15	5	10	5/10
Switzerland	15	5 ⁹	0/10 ^{6,12}	5/10
Turkey	10	10	10	5/10
Ukraine	15	5	10	10
United Kingdom	15	5	0/10 ⁶	5/10
United States	15	5 ⁵	10	5/10

Notes

- Many treaties provide for an exemption for certain types of interest, such as interest paid to the state, local authorities, the central bank, export credit institutions, or in relation to sales on credit. Such exemptions are not considered in this column.
- In the case of two rates, the lower rate applies to equipment rentals.
- There is no withholding tax on dividends paid to non-resident individuals under domestic law; no tax is levied even where a treaty would allow it.
- Usually a 25-percent holding is required for the reduced rates in this column.
- A 10-percent holding is required.
- The zero rate applies to interest paid to a bank (by virtue of the protocol of 2005 between Estonia and the Netherlands and the respective most-favored-nation clauses of the final protocols to Estonia's treaties with France, Spain, Switzerland and the U.K.).
- The value of the (25 percent) holding must be at least EUR 100,000.
- The lower rate applies to equipment rentals and royalties for transmission by satellite, cable, optic fiber or similar technology.
- A 20-percent holding is required.
- The treaty does not apply to income paid to exempt Luxembourg holding companies.
- The zero rate applies to interest on a loan granted to an Estonian enterprise by a Luxembourg bank.
- The lower rate applies to interest on government bonds, etc.

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