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About Estonian New Tax Law

by Lasse Lehis

Introduction

A new Income Tax Act will enter into force in Estonia on 1 January 2000. Under the new Act, legal persons registered in Estonia and nonresidents who have registered in Estonia a branch or other permanent establishment shall no longer pay income tax on the profits earned but rather on the profits distributed. It would not be correct to say that Estonia will henceforth have no corporate income tax or that enterprises will be exempt from income tax. What have been changed are the principles of tax accounting for legal persons. Income tax *per se* shall be preserved, even more so – compared with the current Income Tax Act, the new law will minimise possible loopholes for income tax evasion.

The object of income tax will be turned "upside down". Up to now income tax has been imposed on profit and the law enumerates a number of costs that cannot be deducted from taxable income. Under the new Act, only those costs are subject to taxation. That part of the undertaking's profit which is not withdrawn from the company will remain tax-free. Such a reform will induce the development of enterprising, allow the making of additional investments and create new jobs. Thus, the government of Estonia anticipates that as a result of the new Act, the income of natural persons will increase and private consumption grow, which in turn will facilitate the collection of other taxes. Naturally, the positive impact will not be felt immediately but after years.

Abandoning the taxation of the profit of legal persons is not contrary to the purpose and idea of income tax as such. A legal person in private law is founded in private interests with the goal of earning profit for its owners. Legal person is an abstraction, its activity can only be the expression of the interests and will of the natural persons that create it. Under the new Estonian income tax law, income is understood as the profit withdrawn from enterprise where the beneficiary of that income is either a natural person or a nonresident. Profit may be divided openly (dividends) or covertly (if monetarily appraisable benefits are granted to shareholders or to third persons indicated by them). The principal goal of the new law is to subject all forms of profit withdrawal to taxation with income tax.

A great problem encountered with income tax is the avoidance of double taxation. Many countries permit beneficiaries of dividends to deduct from their income tax the corporate income imposed on the profit share paid as dividend. Under the current Estonian Income Tax Act, profit distributed as dividend is normally subject only to one taxation. But if we think that the entire profit earned by a commercial undertaking shall at some point become the income of owners (the profit is withdrawn from the company as dividend or liquidation distributions, then the income tax collected from legal persons would be merely an advance payment – later the owners shall pay correspondingly less income tax. Consequently, it can be said that in Estonia the moment of corporate income taxation is shifted to a later moment in time – from the moment of earning the profit to the moment of distributing it.

Chapter 10 of the new Act makes an attempt to list all the cases where profit from enterprising could be openly or covertly withdrawn from enterprise. However, only those payments and benefits to natural persons or nonresidents are contemplated there. Transactions by and between resident legal persons will be taxed only in rare occasions – e.g. with non-enterprise expenses it is not important who is the second party to the transaction. There is no need to prevent the exploitation of one undertaking's profit for the development of enterprising, as the profit of both enterprises is exempt from income tax. The income of non-profit associations is also subject to taxation to avoid the giving of tax-free benefits to natural persons.

The new Income Tax Act will eliminate several problems encountered as a result of frequent and poorly analysed amendments to the current Act. Previously, tax incentives were provided only in certain regions and only in respect of investments into noncurrent assets. The new Act treats all investors alike. The profit accumulated in enterprising shall remain entirely income tax free irrespective of whether it is used for purchasing noncurrent or current assets, hiring new personnel or accelerating cash flows.

The previous Income Tax Act was lagging behind the requirements of our time, both in its form and content, and was thus bound to be revised. The Income Tax Act which entered into force on 1 January 1994 was all in all amended on 32 occasions. Many amendments, inserted at different times, contradict each other and prevent effective implementation of the Act. Many tax incentives and exemptions added to the law do not actually live up to their purpose but have rather caused loopholes for tax evasions. Many provisions of law cannot be applied due to lack of related regulations. Such a situation has caused unequal taxation which in turn distorts free competition.

In connection with transition to a new system of income tax accounting, acute attention must be paid to measures that prevent concealed distribution of profit. Thus, the new Act contains a number of restrictions lacking in the old law. For instance, in certain cases, the granting of loans or payment of advances can be taxed. The new Act also provides for withholding tax from payments to legal persons established at low-tax regions irrespective of whether the person operated or did not operate in Estonia. The new Act provides, e.g., for CFC rules under which the profit of commercial undertakings (base companies) located on territories with low tax rates is deemed to constitute resident's taxable income. The law also provides for the tax authority's right to determine the value of transactions between related or associated persons on the basis of market price and thus to demand the payment of additional income tax (so-called transfer pricing).

In drafting the law, the problems encountered in implementing the current Act were carefully analysed and an attempt has been made to eliminate the most widespread methods of tax evasion. Of course, we cannot say that henceforth no tax evasion whatsoever will be possible in Estonia. Democratic states have not yet achieved, and will not achieve, to draft a legislation that would eliminate absolutely all kinds of tax fraud.

Taxation of sole proprietors

Sole proprietors will continue to pay income tax on their income from enterprise minus enterprise-connected expenses. In order to guarantee the exemption of invested profit from tax for this group of taxpayers, the new Act allows the natural persons to use cash basis accounting of their incomes and costs. Thus, they can immediately deduct acquired noncurrent and current assets entirely from income from enterprise. With natural persons, the entire balance of their income shall be treated as distributed profit and, thus, immediately taxed with income tax. A natural person cannot pay dividends or give fringe benefits to himself. His income from enterprise is added to income from other sources and he can make different deductions from his total income which are not allowed for legal persons (e.g. maintenance support, training expenses, home loan interest, payments into voluntary pension fund, carryback of losses).

If the same principles were applied to the enterprise of a natural person as prescribed by the new Act in respect of legal persons, such a person would lose all the benefits. If one type of income of a natural person were to be exempted from income tax, massive tax evasion would become possible. In addition, all the enterprises would have to employ accrual basis accounting for their enterprise. In Estonia, any independent economic activity is treated as enterprising, e.g. farm production or operating as a freelancer. A majority of freelancers would not be able to manage sophisticated accounting and for them the continuance of the current system would be preferable. If a proprietor finds that the tax regime applicable to legal persons is better, he can always found a commercial undertaking. In such a case income tax is imposed on dividends withdrawn from the company. Where income from enterprise is earned directly in one's own name, the net income from enterprise is taxed the same way as dividends.

Will Estonia become a tax paradise?

Estonia is not comparable to tax paradises because accounting and reporting obligations, public registers and the exchange of information between tax authorities shall all be preserved. I emphasise once again that Estonia will not lose income tax but just the moment of taxation will shift to the future. For taxing purposes, Estonia does not differentiate whether a resident's income was earned in Estonia or foreign country. It is not possible to register in Estonia commercial undertakings that would have no tax-paying or reporting obligations – a violation of such obligations is a felony. The Estonian Tax Board will continue to issue information to countries signatories of tax agreements on the incomes earned by their residents in Estonia. Together with adopting a new Income Tax Act, provisions regarding the giving of information to tax authorities have become stricter while the tax authorities are granted additional rights to inspect and collect taxes. In addition, it is planned to increase penalties for violation of tax law.

Under the new Act, all the payments made to natural persons and forms of hidden profit transfer are taxed. In preparing the Act, the aim was to ensure that the new tax regime of Estonia could not be abused in foreign countries for the purpose of evading income tax.

It is extremely important to clarify that income tax will not be waived in Estonia but just the principles and methods of corporate income taxation will be changed. Current negative feedback is in my opinion mostly attributable to inadequate or distorted information. Unfortunately, neither the Government of Estonia nor the Ministry of Foreign Affairs has been very active in presenting our tax reform in foreign countries. The process has been obstructed by the fact that the preparation and consummation of the Act were more time-consuming than planned – the Act was not adopted until 15 December. Thus, it was not possible to notify other countries about the adoption of the new Act at an earlier date.

The new income tax system to be applied in Estonia is without a doubt new and unknown and differs substantially from the tax systems of other countries. Therefore, we cannot rule out the possibility of discords which could not have been foreseen upon drafting the Act. Naturally, the Government of Estonia cannot guarantee that all the foreign states will alike understand what happens here and that there will not be any sanctions towards Estonia. It is not impossible that already now Estonia is treated as a tax paradise with all the related consequences by some country. Each country has a different tax system and the slightest discrepancy may cause collisions in either direction – cause double taxation or enable tax evasion.

The new income tax law may bring about new instances of double-taxation between countries. For instance, under the new Act the permanent establishment of a nonresident is taxed on the same bases as the resident. Therefore, in case of a permanent establishment it is not the profit earned which is taxed but the profit which is taken out of Estonia. Such an approach is conditioned by requirements of the WTO agreement and interstate tax agreements under which towards permanent establishments a regime which is at least as beneficial as the one applicable towards a resident must be applied. However, a nonresident pays in his state of state income tax on the entire profit earned by him (including that earned in Estonia). As in Estonia additional income tax is payable later on the withdrawal of profit, the profit shall at least in part be taxed twice. It is not very likely that a foreign country would be willing to refund the Estonian income tax to its resident. The problem could be solved only by changing the tax agreements. Fortunately, there exists a simpler solution: if a nonresident founds an independent legal person (subsidiary) instead of a permanent establishment, then only withdrawn dividends shall be subject to taxation with income tax and double taxation can be avoided by the so-called traditional methods.

Structure of Act

The Act essentially combines two independent taxes. The first is the classic income tax payable by natural persons and nonresidents on their income. The other is the so-called profit distribution tax targeted at the payments made by resident legal persons or permanent establishments. The first two chapters of the Act provide for general provisions and definitions which are applicable to both taxes. Chapters 3 through 9 concern the income tax payable on income and Chapter 10 is about the income tax on special object(s). With both taxes, the object of tax, taxpayer, tax rate, taxation period, declaration and procedure of payment are all different. What is common is just the name of tax. Hereinafter, the taxes will be referred to respectively as income tax and profit distribution tax.

A calendar month is the taxation period for the profit distribution tax. The profit distribution tax is entirely received by the State. Income tax is reported on one return together with the income tax withheld from natural persons and social tax. In Estonia, social tax is a state tax which is fully payable by the employer. The rate of social tax is 33% while the rate of profit distribution tax is 26/74 which is calculated on the net amount of profit distribution or payment. The result equals to a 26% withholding from income before taxes. For accounting purposes, income tax is entered on the same expense line as the corresponding payment. Thus, the income tax paid on dividend is also treated as a distribution of profit.

Payments taxed with the profit distribution tax are not deemed to constitute the income of the beneficiary – he need not declare it and cannot make any deductions from it. The principle of profit distribution tax is applicable to all types of legal persons. Non-profit associations, foundations and legal persons in public law pay income tax in accordance with the same principles as commercial undertakings. Although with these organisations, the distribution of profit is usually not allowed, they may, e.g., make taxable gifts or give fringe benefits. The State and local governments pay income tax solely on fringe benefits.

The advantage of the profit distribution tax lies in the fact that as a beneficiary of income cannot make any deductions from the income, a maximum collection of tax is guaranteed. Besides, such an administration of taxes is more streamlined – there is less income reported by natural persons, there are less omissions and adjustments. A disadvantage is that where a natural person's income is fully derived from dividend, he cannot apply any deductions or tax incentives, not even tax-free income.

As the profit distribution tax is paid by an Estonian resident, no tax agreements apply to it and therefore it is possible, e.g., to subject the dividends paid to nonresidents to double taxation. Where dividend is received by a nonresident, under the law the payer of dividend shall pay 26/74 on the amount of dividend and then additionally withhold the income tax of 26% on the dividend. Where dividend is received by a legal person whose interest in the commercial undertaking paying the dividend is at least 25%, no income tax will be withheld. What should also be taken into account is that the withholding of income tax may also be reduced to 15 or 5 per cent under provisions of tax agreements.

Such a system may cause additional double taxation. E.g., it may happen that fringe benefits granted to a nonresident are taxed in his country of seat but he cannot take into account his Estonian income tax – because it has not been paid by him or withheld from him. To avoid such situations, the employer must report fringe benefits as salary income (related taxation rates are equal) – in such a case it shall be deemed to constitute the nonresident's income and the income tax withheld on that can be treated as income tax.

An important condition precedent to the functioning of the profit distribution tax is naturally a proportionate income tax rate for natural persons. If the rate was progressive, the profit distribution tax could not be applied in most cases, as each payment must be added to the income of each particular beneficiary.

The profit distribution tax has another advantage. Namely, it enables to tax payments where the specific beneficiary cannot be identified, such as various non-enterprise expenses or fringe benefits granted to a large group of persons. This method provides the tax authorities with a better possibility of tax administration. What should also be mentioned is that a shorter taxation period enables the tax board to begin inspecting tax accounting at a considerably earlier date. On the other hand, tax claims expire in a shorter time (in Estonia tax authorities can generally designate additional tax payments during three years or, if the violation was intentional, during six years).

Taxation of personal income

A resident natural person shall pay income tax on all income received from any sources of income anywhere in the world. Income received from a foreign country is subject to taxation pursuant to the general procedure. The credit method is applied to avoid double taxation – income tax paid in a foreign country may be deducted from the income tax payable in Estonia. The credit method is specified in the majority of Estonia's taxation agreements. The only exception is taxation agreements with Latvia and Lithuania – the exemption method is applied to income from wages and income from enterprise received from these countries.

The Act specifies nine categories of income:

(1) income from wages;

(2) income from enterprise;

(3) income from transfer of property;

(4) rental income and licence fees;

(5) interests;

(6) dividends;

(7) maintenance support, pensions, scholarships, benefits, awards, lottery prizes;

(8) insurance benefits and payments from pension funds;

(9) income of legal person located in a low tax rate territory.

As the list of categories of income is incomplete, this classification has no substantial legal relevance. The list of categories of income, however, is relevant with regard to Sections of the Act specifying the withholding of taxes and taxation of the income of a nonresident. Deductions may be made only from income from enterprise and income from transfer of property. All other categories of income are subject to taxation by using the gross amount of expense as the tax basis. Loss from sale of securities may be deducted from income from sale of other securities; where no deductions can be made for the financial year, the loss may be transferred to the following years. Enterprise loss may be transferred to up to five following taxation periods. Transfer to previous years is not allowed. A sole proprietor may at once deduct from his or her income the entire cost of the property acquired. When selling such property later, however, the selling price of the property has to be added to income from enterprise (on which social tax shall be paid). When the sole proprietor terminates the use of the property for enterprise purposes, he or she has to pay income tax on the market value of the property.

Rental income and licence fees (royalties) are subject to taxation by using the gross amount of expense as the tax basis, but the receiver may declare this category of income as income from enterprise. In such case, he or she may make deductions from the income, but has to pay social tax on profits. One may register as a sole proprietor with the Tax Board or in the Commercial Register.

As mentioned above, payments subject to the distribution of profit tax (such as dividends, gifts, and fringe benefits) are not considered to be personal income. Therefore, a natural person shall pay income tax on only, for example, dividends received from a foreign country.

Payments concerning the repurchase of shares or reduction of share capital are not subject to taxation as dividends, but are considered to be shareholder's income (income from sale of property). Liquidation allotments and gains from sale of stock are subject to similar taxation. The reason for this is the fact that gains are calculated from the acquisition cost of stock, of which the commercial undertaking that makes the payment might not always be aware. The Act obliges a commercial undertaking to notify the Tax Board of all such payments.

The main tax exemptions are the following: business travel costs, return of property under the ownership reform, receipt of inherited property, sale of movable property in personal use, sale of home, state pensions, scholarships, social benefits, aid payments, and lottery prizes from lotteries organised under an operating permit. Property insurance benefits are subject to taxation only where the insurance premiums were earlier deducted from income from enterprise. Exemption applies to all interests received from Estonian credit institutions.

Natural persons may deduct the following costs from their taxable income;

(1) maintenance support paid (income tax is paid by the receiver of the maintenance support);

(2) interests on home loan;

(3) training costs of the taxpayer or person dependent on the taxpayer;

(4) donations made to non-profit associations (up to 5% of taxable income);

(5) voluntary pension insurance premiums (up to 15% of taxable income).

The taxation period for income tax is the calendar year. The tax rate is 26%. As an exception, voluntary pension insurance premiums are subject to a 10% tax rate in certain cases. A proportional tax rate has been applied in Estonia already since 1994. Although several attempts have been made to introduce a progressive income tax and heated discussions have been held on the topic, the attempts have not succeeded. The tax-free income of a resident natural person is 9600 kroons per year. In most cases, income tax is paid by withholding. All resident natural persons must submit an income tax return, except where income has been received from a single employer throughout the year. Spouses may submit a joint income tax return. The submission deadline for the income tax return is 31 March; payments of additional amounts of tax due and tax refunds shall be made by 1 July, and by October 1 concerning sole proprietors. Of the income tax of a resident natural person, 44% is paid into the state budget and 56% into the budget of the rural municipality or city of his or her residence.

Taxation of income of nonresidents

Nonresident is a person with limited tax liability, their taxable income consists only of income gained from an Estonian-based source of income. Nonresident natural and legal persons shall pay taxes according to the same principles. Nonresident legal persons with a registered permanent establishment shall be exceptions – they shall be taxed on the basis of profit distribution tax analogously to resident legal persons.

Tax shall be imposed on the income from wages of nonresidents, if the nonresidents performed their work or service tasks in Estonia and the payment was made by the state, a local government entity or a resident or the payment was made through a permanent establishment registered in Estonia of a nonresident legal person. Also, remuneration of the members of the management board or supervisory board, paid by resident legal persons, shall be taxable income of nonresidents.

Income tax shall be imposed on income from enterprise, if the enterprise of the nonresidents was carried out in Estonia. Permanent establishment is not necessary. In case of legal persons established in low-taxed territories, income tax shall be imposed on all service fees paid by Estonian residents notwithstanding the place where the service was provided.

Income tax shall be imposed on gains from transfer of immovable property situated in Estonia and movable property entered into register in Estonia. Income tax shall be imposed on sale of other property situated in Estonia, if the immovable property is transferred to the state, a local government entity or a resident. Also, tax may be imposed on gains from sales of participation in a commercial undertaking, if the participation was not less than 10%, and more than 75% of the assets of the commercial undertaking consist of immovable property or buildings located in Estonia.

In addition to that, income tax shall be imposed on gains from commercial letting of immovable property located in Estonia and movable property registered in Estonia or used in Estonia. Royalties shall be taxed, if the rights acquired or used for royalties are used in Estonia or if they are used by the state, a local government entity or a resident.

Income tax shall be imposed on interest received from the state, a local government entity or a resident. Interest paid by resident credit institutions shall be exempt from income tax. Interest received by foreign credit or financing institutions from Estonia shall be exempt from income tax as well.

Income tax shall be imposed on liquidation distribution received from resident legal persons or payments related to redemption of stocks or shares or reduction of stock or share capital. Income tax shall also be imposed on dividends received from a resident commercial undertaking (except in cases where the recipient of the dividend is a legal person and the participation in the capital of the commercial undertaking paying the dividends is not less than 25%). As it was indicated above, dividends paid to nonresidents shall be subject to double taxation. The income tax withheld on dividends can be accounted for in taxation in the country of seat of nonresidents.

Income tax shall be imposed on non-state pensions and stipends, awards, benefits and lottery prizes, insurance benefits paid by Estonian residents to nonresidents; payments made from the Estonian pension fund shall also be taxable. In addition to that, income tax shall be imposed on remuneration paid to nonresident artists or sportsmen for their performance or performing of their works in Estonia – this also applies in cases where the remuneration is received by a third party.

Taxation of income of nonresidents shall generally be performed by withholding income tax. The rate of income tax to be withheld shall be 26%, except for royalties, remuneration for the performance of artists or sportsmen and remuneration for services provided in Estonia in which case the rate of income tax to be withheld shall be 15%. In such cases, the withheld income tax shall be the final tax in Estonia. Nonresidents shall present income tax returns on gains from transfer of property or enterprise.

At this point, it should be borne in mind that the tax agreements concluded by Estonia in many cases restrict taxation of income of nonresidents. At the moment, Estonia has concluded tax agreements with 21 states in total: Finland, Sweden, Denmark, Latvia, Norway, Lithuania, Poland, Great Britain, Iceland, Czech Republic, Canada, the Ukraine, Germany, Belorussia, the Netherlands, Italy, France, France, Ireland, the USA, Moldova, and China.

Taxation of Profit Distribution

According to the new act, resident legal persons shall pay income tax on the following payments: fringe benefits, gifts and charitable donations, reception costs, dividends, hidden profit distribution, non-enterprise expenses.

Employers shall pay income tax on fringe benefits. Here belong also individual employers and state and local government authorities. Income tax shall be imposed on all monetarily appraisable gifts, favours and other benefits granted to employees, public servants or members of directing and control bodies. Among else, payoff of a loan or purchase of property at a price which is higher than the market value are considered fringe benefits for example. If the fringe benefits were granted to a person related to the employee, income tax shall be imposed on them in the same manner.

Taxation of gifts and charitable donations depends on the recipient of the charitable donation. Tax shall not be imposed on charitable donations made to state or local government authorities. Taxation of charitable donations made to non-profit undertakings depends on the status of the recipient of the donation. The government shall approve a list of non-profit undertakings and foundations whose activities are aimed at supporting science, culture, education, sports, health care, social welfare, preservation of nature etc. in the public interest. Upon entry into the list, the documents and activities of the organisation shall be carefully checked. If the organisation fails to conform to the requirements, it shall be deleted from the list. For example, such associations must not deal their assets or income to their members, their administration costs and remuneration must not be too large in comparison with undertakings. Tax allowances shall automatically be granted to churches and congregations, as well as to political parties.

Income tax shall be imposed only partially on the associations and foundations entered into the list – in the amount exceeding 2% of the total remuneration paid to employees during the previous calendar month, on which social tax was imposed. Income tax shall be imposed on all other charitable donations in full. If a gift is made to an employee, this is a fringe benefit on which social tax shall be paid.

If a commercial undertaking does not make charitable donations every month, income tax may be recalculated at the end of the year. Otherwise it would be in an unfavourable situation as it could not use the tax-free limit for those months when it did not make any charitable donations. But this would impede making of larger donations.

Income tax shall be paid on dividends, if the recipient is a natural person or nonresident. Income tax shall also be paid in cases where laws prohibit payment of dividends (for example, when the commercial undertaking is in the red). If the illegal payment is refunded, the commercial undertaking may also apply for the refund of income tax. Income tax shall also be paid on other hidden profit distribution, such as transfer of property at a price which is lower than the market value, or vice versa, purchase of property at a price which is higher than the market value. If the commercial undertaking grants a loan to its shareholder that is prohibited according to the Commercial Code, income tax shall be paid on the amount of the loan as well.

The cases listed above concerned hidden profit distribution made to a shareholder or stockholder of a commercial undertaking. In addition to that, the act comprises a so-called transfer price provision. If the value of a transaction performed between a resident legal person and a nonresident connected with them differs from the value of a transaction performed between independent persons, a tax authority may impose income tax proceeding from the value implemented in similar conditions by independent persons.

In addition to the above-mentioned, resident commercial undertakings shall pay income tax on non-enterprise expenses. Here belong, for example, fines, compensation for damage incurred to the environment, undocumented payments, and all costs unconnected with business. In brief – such expenses that could not be deducted from taxable income upon taxation of profit. Non-profit undertakings shall pay income tax on such expenses that are unconnected with the goals of their activities.

As acquisition of property, granting of loans and making of advance payments cannot be considered expenses, the act contains a separate paragraph that provides also for taxation of such expenses. Income tax shall be paid on the cost of property unnecessary for enterprise and a series of payments made to legal persons established in low-tax territories, such as acquisition of participation, acquisition of securities, payment of penalty clauses, granting of loans, or making of advance payments. If such payments prove to be justified or the loans are repaid later, the commercial undertaking shall have the right to demand income tax refunding.

Granting of fictitious loans to natural persons is a common type of fraud. In order to impede it, the act provides for that if legal persons have, as of the end of a month, granted to natural persons loans or advances in the amount exceeding 50% of the funds meant for wages that month, income tax shall be paid on the part exceeding the limit. Once again, we must point out that refund of income tax may also be demanded after repayment of loans.

Income tax shall be imposed on the profit distribution of nonresident legal persons having a permanent establishment on the same grounds as for residents. As the permanent resident is not an independent legal person, it is rather difficult to determine the dividend paid to the headquarters. Separate accounts shall be maintained for the permanent establishment under the requirements of Estonian legislation. Accounting entries can, first and foremost, serve as the basis for profit distribution. However, the situation becomes difficult when the accounts of the permanent establishment also contain income gained from outside Estonia. Such income shall not be taxed according to the foreign treaties of Estonia. Additional accounting rules that would allow to proportionate profit shall probably be established in such case.

According to the act, the case is about the distribution of profit of the permanent establishment if more of the property of the permanent establishment is imported from Estonia than has been imported to Estonia and if no other property or service is provided for that property. Secondly, income tax shall be imposed on payments made to the headquarters or other structural units outside Estonia via the permanent establishment or on the account of the permanent establishment, for which no good or service is provided. Payments made to third persons shall be taxed in the same manner. Assessment and control of services provided by the headquarters to the permanent residence may prove problematic.

Problems of Transfer

In relation with changes in the taxation principles, a series of problems of transfer shall be solved. A whole chapter is provided for that in the Income Tax Act. The majority of the problems are technical and are of no interest for the foreign reader. One of the important transfer provisions, on which the author chooses to focus, is prevention of double taxation of dividends.

According to the new act, income tax shall be imposed on profit distribution notwithstanding the period whose profit is distributed and whether and how much income tax has been paid on the profit. In order to avoid double taxation, income of the undertaking corresponding to the distributed income may be deducted from income to be paid on dividends. Only actually paid income may be deducted. For that purpose, the effective rate of tax is calculated for 1994–1999 (income tax divided by profit according to the balance sheet) and according to that rate the income tax paid on the dividends payable for these years may be reduced to zero. If the undertaking did not pay income tax for these years (for example, due to tax allowances), the income tax paid on dividends shall not be reduced. Deductions can not be made from income tax paid on hidden profit distribution and non-enterprise expenses.

If one Estonian enterprise pays dividends to another Estonian enterprise, income tax shall not be paid on dividends – consequently, deductions can not be made either. If the recipient of dividends pays dividends to natural persons or nonresidents from the money gained, it shall be subject to a tax liability; however, it may not be possible to deduct the previous income tax. In that case, the right to deduct income tax shall be transferred to the recipient of the dividends and an appropriate certification thereof shall be presented to the Tax Board. In the same manner, the right to deduct income tax may be transferred upon fund issue. Income tax may be transferred only to those stockholders or shareholders whose participation amounts to at least 20%. The number of transfers is not limited – this may be done as long as a tax liability and possibility to deduct are created.

One problem, however, has passed unnoticed in the act. If a commercial undertaking that is an Estonian resident has gained profit from foreign states (for example, dividends or royalties) and has paid income tax in the foreign states, it is not possible for it to deduct the tax paid in the foreign states from its Estonian income tax. The provision regulating the deduction of income tax paid in foreign states applies only to natural persons. One argument is that as income is not taxed in Estonia, double taxation is thus avoided. As tax is still imposed on profit distribution, income tax actually also exists, of which income tax paid in foreign states could be deducted. It seems that only a direct application of a foreign treaty would solve this problem. In most tax agreements, Estonia has assumed a liability to use credit method in order to avoid double taxation. In practice, the application of the foreign treaty may involve several complications and misunderstandings. Therefore, it would certainly be more reasonable if the Estonian act provided for an appropriate procedure – then it would be equally known and understood by everybody.

What about the future?

At the moment, it is hard to predict what changes will accompany the new act. It is clear, however, that a new accounting procedure will cause much confusion at first, many mistakes will be made upon filling in the income tax return formats and diverging opinions concerning interpretation of the act may emerge. As there is no acceptable foreign standard for that pattern of taxation, we lack a source providing ready-made solutions for solving the problems that may evolve. It is rather likely that soon the act has to be amended and supplemented.

As a result of the income tax reform, the state budgetary income shall decrease substantially in 2000. If the planned amount of corporate income tax to be collected in 1999 was 1.5 billion kroons, then the amount of income tax to be collected in 2000 would be 628.8 million kroons. A part of it will be made up by additional amount of income tax calculated on the profit of 1999 and a part will be made up by profit distribution tax to be collected under the new Income Tax Act.

Due to the declining importance of income tax, the importance of indirect taxes in the Estonian revenue from taxes will continue to increase. In 1999, for example, the proportion of VAT and excise duties was 53% and by 2000 it will be already 58.5%. In addition to the changes concerning income tax, increase in the rates of excise duties and abolishment of several VAT exemptions in 2000 will facilitate the increase. In addition to that, a significant increase in state fees and fines has been planned for 2000. All this has naturally caused severe criticism on the part of the opposition. The government is blamed for supporting a small group of successful traders as a result of which the economic condition of the majority of population would deteriorate. Against this background, the initiative of the Government of Estonia should be considered a very courageous attempt.

The new Income Tax Act has certainly achieved one of its goals already by now. Activities in Estonia are monitored with great interest by foreign states. An ordinary European considers Estonia a faraway small country of which little is known and which is infrequently talked about. Therefore coming into the focus of the world press is an important event for Estonia. The initiators of the income tax reform claim that Estonia has exhausted nearly all of its former advantages to attract foreign investors and that the new Income Tax Act might become the factor that attracts attention to Estonia and makes Estonia more attractive for foreign investors. At the same time we are well aware of the fact that the Income Tax Act is not the most important indicator for foreign investors. Certainly there are also areas in the word where investors would refuse to place their money even though they would be compensated for that. Naturally, attention is also paid to all other factors influencing the investment climate in Estonia, such as development of infrastructure, vocational training reform, restraining of bureaucracy and corruption, increasing the efficiency of court system, etc.

Success and fame of Estonia have, in large part, relied upon courageous economic reforms. Liberal economic policy, stable Estonian kroon, balanced budget, conservative loan policy, rapid transfer to market economy, large-scale privatisation of state enterprises, absence of custom duties, proportional income tax – these are the keywords that characterise the development of Estonia after re-establishing its independence. The new Income Tax Act will be the next significant step declaring the continuation of our liberal economic policy.

ESTONIA COUNTRY REPORT

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I. INTRODUCTION

In the first years of its independence from 1870 to 1917, Estonia had a very large and well-developed non-profit sector. In fact, it has been said that the Republic of Estonia owes its first independence to the non-profit organizations (NPOs) because the sector helped organize a civil society that laid the foundations for strong statehood. During the Soviet occupation, one of the first tasks of the Soviet occupation powers in 1940 and again in 1944, was to ban unions and non-profit organizations. Only a few were given permission to form during that time and throughout the Soviet rule but they were subject to very strict state and communist party control. Eventually, the perestroika years saw a relaxation of party control over citizens' activities, which, in a very archaic way, introduced the right of the people to associate. In 1989, the Supreme Soviet of the ESSR adopted the Law on Associations of Citizens, common in all transitional countries. This was revolutionary because it released associations from communist party control. After regaining independence in 1991, the Estonian government commenced preparation for new legislation to govern the activities of NPOs in Estonia. The Constitution of the Republic of Estonia, adopted on June 28, 1992, served as the basis for forming the non-profit sector and provided a general framework for the regulation of NPO activities.

II. PROVISIONS OF THE GENERAL LAWS

A. Consistency and Clarity

There are two main laws dealing with NPOs in Estonia: the Foundations Act (FA) and the Non-Profit Associations Act (NPAA). In addition, there are special laws for political parties, trade unions, churches and religious confessions, apartment associations, and for state participation in NPOs. Today, Estonian NPO legislation is very modern and clear, and it is in conformity with international best practices.

B. Constitution

According to the Constitution of the Republic of Estonia (hereinafter EC), "Estonia is a sovereign and independent democratic republic wherein the supreme power of the state is vested in the people."(EC, Article 1). The second chapter of the Constitution (Articles 8 to 55) defines basic rights, freedoms and duties of individual citizens and legal entities. Article 19 of the Constitution grants the individual right to self-realization. It also espouses that "everyone shall honor and consider the rights and freedoms of others, and shall observe the law, in exercising his or her rights and freedoms and in fulfilling his or her duties." In addition, every citizen of Estonia has the right to freely exercise his or her sphere of activity, profession, and place of work (EC, Article 29). This right includes not only the freedom to engage oneself in an enterprise and to form commercial undertakings and unions (EC, Article 31), but also the freedom to form non-profit organizations.

Freedom of association is generally expressed in Article 48 of the Constitution, which clarifies the context of the right to assemble and sets up some restrictions. According to this article, only citizens of Estonia may belong to political parties. The establishment of organizations and unions whose purposes are to possess weapons, to perform military exercises; or which are military in nature requires prior permission, the conditions and procedures for which are provided by law. Organizations, unions, and political parties whose aims or activities are directed at changing the constitutional order of Estonia by force, or which are otherwise in conflict with the criminal law are not permitted to exist. For the general protection of the rights of formed non-profit organizations, the Constitution provides that: "Only a court may terminate or suspend the activities of, or fine an organization, union or political party, for violation of the law." (EC, Article 48).

In 1994 a new Law on Non-Profit Associations and their Alliances was introduced. Basically this law continued the tradition of the Soviet administration-controlled and restrictive regulation of NPO activities (e.g. registration of NPOs by government offices with broad discretion, prohibition of legal entities for members and founders of NPOs, no distinction between member-based and capital-based organizations, and so forth). There was also a mix of civil law and public law norms. Many problems arose as a result of the conceptual uncertainty with regard to the regulation of legal entities. The General Principles of the Civil Code Act (hereinafter GPCCA), which was adopted in 1994 and came into force on the 1st of September, 1994, helped to clarify the situation with respect to legal entities and gave a proper basis for further regulation. Under the GPCCA, different legal entities must have their own regulations, which led to the preparation of new laws governing NPOs.

The Foundations Act (thereinafter FA) was adopted by the Riigikogu on November 15, 1995, and the Non-Profit Associations Act (thereinafter NPAA) on June 6, 1996; both entered into force on October 1, 1996.

C. Types of Organization

According to Estonian laws, there are three types of non-profit organizations: the foundation (sihtasutus); the non-profit association (mittetulundusühing); and the non-profit partnership (seltsing). Foundations and non-profit associations acquire the status of a legal entity upon registration, whereas non-profit partnerships need not be registered. In addition, it is possible for state and local governments to establish under special law, public legal persons such as the Cultural Endowment of Estonia.

A "non-profit partnership" is created simply by an agreement between two or more persons to carry on a non-profit purpose. Since there is no requirement to register, it lacks the status of legal entity. The provisions for civil (private) law partnership apply. Because part of the Civil Code regulating their activities (i.e. the Obligations Act) has not yet been adopted (the draft is now in Parliament and will most likely be passed during the year 2000), no further discussion will be given to "non-profit partnerships."

A foundation, recognized as a legal person in private law, is established to administer and use assets to achieve the objectives specified in its Articles of Association. Since a foundation has no members, it is governed according to the law and its Articles of Association. Upon the transfer of assets to a foundation, the founders' right to direct their use is generally extinguished.

A non-profit association is a voluntary association of persons, both physical and legal, whose main activity cannot be based on economic activity. The income earned may only be used to achieve the objectives specified in the Articles of Association. A non-profit association is governed by the members and its internal documents (e.g. the Articles of Association).

Estonian civil law does not distinguish between NPOs acting for the public benefit and NPOs acting for the mutual benefit of their members. Rather, the distinction between public and mutual benefits is defined in the tax laws, where only public benefit organizations are entitled to tax exemptions. In addition, the NPAA provides for the existence of specific regulations for particular classes of non-profit associations. For example, there are special laws on political parties, churches and religious confessions, trade unions, and apartment associations.

D. Purposes

Estonian legislation does not set limits nor specify the purposes for which NPOs can be established. Only one restriction exists, which states: "Organizations, unions, and political parties whose aims or activities are directed at changing the constitutional order of Estonia by force, or are otherwise in conflict with the law providing for criminal responsibility, are prohibited." (EC, Article 48). Consequently, the purpose of a non-profit organization must be determined when it is founded. It can only be changed by amending the Articles of Association. Moreover, under the GPCCA, the Minister of Interior has the right (and duty) to bring cases for compulsory dissolution of non-profit organizations when the objectives and activities of the association are: (1) contrary to law, the constitutional order, or good morals; (2) do not comply with the objectives in the Articles of Association; or (3) when economic activities become the main activities of the non-profit association (NPAA, Article 40(1)(i), (ii), (iii)). See below under Part IV, Section B.

E. Registration Requirements

The requirements for the registration of non-profit organizations have gone through significant changes since Estonia regained its independence. No longer is there a centralized party system and a government controlled registration system. Nowadays, registration occurs locally in local courts.

To establish a NPO, there are some basic requirements. First, in the case of a non-profit association, the founders must enter into a foundation agreement (NPAA, Article 6 (1)). Founders of a foundation must adopt a foundation resolution (FA, Articles 6 and 7), which may also be a part of a notarized will. Registration takes place in the registration departments of city and county courts, where registers of non-profit associations and foundations are maintained.

The founders of an NPO may be physical or juridical persons. In some cases, a special law will mandate that founders and members of different organizations, such as political parties, may only be physical persons. The NPAA states that non-profit associations may be founded by at least two persons (NPAA, Article 5). Foundations, however, may be founded by only one person.

NPOs obtain the status of legal personality upon registration. To establish itself, a non-profit association or foundation must develop a foundation agreement or foundation resolution, the Articles of Association must be approved, members of the management board and other bodies prescribed by the Articles of Association must be appointed, and the management board must submit an application for registration.

The registration application must include the following documents: a foundation agreement or resolution; the Articles of Association; a bank notice concerning the money transferred to the foundation; the names, personal identification codes and residences of the members of the management board (identified in the foundation agreement or resolution) with their notarized signatures, telecommunications numbers and, if requested, other documents such as the minutes from its first general assembly meeting; bank receipts from the payment of the state fee; a list of members, etc. (NPAA, Article 8 and FA, Article 11). The signature on the application submitted to the registrar must be notarized.

There is no obligation for an association to have an endowment. In the case of a foundation, the law does not require a minimum initial endowment for registration but the foundation can be dissolved by a court order if its assets are clearly insufficient for the achievement of its objectives, and acquisition of sufficient assets in the immediate future is unlikely (Article 46). In practice Article 46 has not yet been applied to dissolve a foundation.

The register of non-profit associations and foundations is managed by special registration departments in the county and city courts. Entries in the register are public and everyone has the right to examine and obtain of copies of registry cards and documents in the public files (NPAA, Article 77). Currently, an electronic central register is being developed and will soon be available to the public.

The register is headed by a judge, who also has the responsibility for registration. If the registration is rejected (because the submitted documents do not comply with the law), the applicant has the right to appeal to the appellate court.

Re-registration of non-profit associations and foundations founded before the enactment of the new laws on October 1, 1996, is free. The only expense required by law is the fee to the notary for the authorization of the foundation agreement or resolution, the notarization of signatures on the application for registration and the signatures of the members of the management board. The cost is approximately 500-1000 Estonian Crowns (EEK), or $35-$70 US. For a "new" non-profit association and foundation, it is necessary also to pay the state fee of 300 EEK ($22 US) for the initial registration. If changes are required on the entries, the state fee is 100 EEK or $8 US. (The fees have since been changed due to the recent amendments of the State Fees Act and are higher as of January 1, 2000.)

F. General Powers

Generally, foundations and non-profit associations are permitted to engage in any activity so long as the activities correspond to the purposes stated in their Articles of Association. Restrictions on economic activities of foundations and non-profit associations may be provided by law (FA, Article 2 and NPAA, Article 1). Some restrictions on economic activities may also be provided for political parties.

Foundations and non-profit associations may use their income only to achieve the objectives specified in their Articles of Association. Economic activity may not be the main activity of an NPO. If an economic activity becomes predominant, the NPO must reform as a business association or form a subsidiary business association according to the Commercial Code. In all cases, any interested person can raise an issue on the failures of a NPO to comply with the limitations provided by law. The Minister of Interior has a special right and duty to do this (NPAA, Article 40 and FA, Article 46).

G. Membership Organizations

The NPAA governs membership organizations. Under the law, the management board decides on the admission, removal or exclusion of members unless this responsibility is placed in the competence of the general assembly or other body according to the Articles of Association (NPAA, Articles 13 and 16). If the person does not agree with the decision of the management board, the final decision is made by the general assembly. Every member of an association has the right to leave a non-profit association upon request. But the Articles of Association may prescribe that a member may only leave at the end of a financial year or after the expiration of a term, for which advance notice shall be no longer than two years (NPAA, Article 15).

III. GOVERNANCE

General Rules. The general regulations for governance of NPOs are provided for in the GPCCA. The regulations require the following: a compulsory management organ or management board; personal liabilities for intentional harm caused to the organization or third parties; and general norms for the winding up and liquidation of legal entities.

Associations. Chapter 4 of the NPAA establishes two compulsory management structures and also outlines their responsibilities. Every non-profit association must have a general assembly as the highest governing body and a management board (one or more members), which manages and represents the association. Also, because of a very large variety and size of non-profit associations, the law provides for the possibility of forming other governing bodies, with their own management, and committees for solving disputes between members. All members of the non-profit association may participate in the general assembly, which is empowered to amend the Articles of Association, change objectives and appoint members to the management board. Additionally, unless the Articles of Association provide otherwise, the general assembly has the power to elect members to the other bodies, decide on entry into transactions with members of the management board or other body, decide on the assertion of claims against members or appointing a representative of the non-profit association in such transactions and claims, and decide on other matters which are not placed in the competence of other bodies by law or the Articles of Associations (NPAA, Article 19).

A resolution of the general assembly is adopted if over 1/2 of the members or their representatives present at a meeting vote in favor of the resolution, unless the law or the Articles of Association prescribe a greater majority. The consent of all members is required in order to change an objective of the non-profit association, amend the Articles of Association, or dissolve the non-profit association. Unless the Articles of Association provide for a greater majority requirement, for mergers or dissolutions, over 2/3 of the votes from members participating in the general assembly are required.

Foundations. Foundations are governed by two compulsory bodies - the management board and the supervisory board. The supervisory board must have at least 3 members who are natural persons with legal capacity. The procedure for the appointment and removal of the supervisory board must be provided for in the Articles of Association (FA, Article 27). Usually the founders of a foundation reserve for themselves the right to appoint members of the supervisory board. The term of office for the members of the supervisory board is not prescribed by law and may be clarified in the Articles of Association. The supervisory board plans the activities of the foundation, organizes the management of the foundation, and supervises its activities. Generally the consent of the supervisory board is required for the management board to enter into transactions, which are beyond the scope of everyday economic activities (FA, Article 25).

The management board may consist of one or more members. The residence of at least 1/2 of the board members must be in Estonia. If the Articles of Association determine a set of beneficiaries, they or persons with an equivalent economic interest shall not be members of the management board (FA, Article 17). A member of the supervisory board or person in bankruptcy may not be a member of the management board. The members of the management board shall be appointed by a resolution of the foundation and any changes to its membership are decided by the supervisory board (FA, Article 19). The term of the office for members of the management board shall be set up in the Articles of Association. The management board manages and represents the foundation as well as runs its everyday businesses (FA, Article 17).

Liability for Damages. All members of the governing bodies are personally liable for damage wrongfully caused to the organization either by violation of the requirements of law or the Articles of Association, or by failure to perform their duties in the manner required. In addition, members of the governing bodies are personally liable to the organization's creditors if they wrongfully cause damage to the creditors by failure to perform their duties or by failure to perform their duties in the manner required (FA, Articles 23 and 32 and NPAA, Article 32). The limitation period for assertion of a claim against a member of one of the governing bodies is 5 years from the occurrence of the violation.

Self-dealing. The Foundations Act provides "...foundations shall not grant loans to or secure loans of founders or members of the management board or supervisory board of the foundation, or of persons with an equivalent economic interest, unless otherwise provided by law." (FA, Article 2).

IV. DISSOLUTION, WINDING UP AND LIQUIDATION OF ASSETS

A. Voluntary Dissolution

According to Article 37 of the NPAA, the general assembly has the power to adopt a resolution dissolving the association. A foundation is dissolved by the resolution of the supervisory board, or by the resolution of the founders, if this right is prescribed for them in the Articles of Association. The Articles of Association may also provide other bases for dissolution. (FA, Article 43) For instance, dissolution can occur upon the fulfillment of the purposes of a foundation, or voluntarily, or by the court at the request of the Minister of Internal Affairs. (FA, Article 46(1)(4))

Associations have dissolution procedures similar to those for foundations. In the case of an association, the vote for dissolution must be supported by at least 2/3 of the members who participate in or are represented at the general assembly if the Articles of Association do not prescribe a greater majority. Usually a non-profit association is liquidated through a liquidation proceeding. The liquidators are appointed by the general assembly. They have the power to terminate the activities of the non-profit association, collect debts, sell assets, satisfy claims of creditors and distribute the assets after satisfaction of the claims of creditors (NPAA, Article

45). Liquidators have a duty to publish a notice of the liquidation proceeding in a national newspaper and in the "Riigi Teataja Lisa" (State Gazette) so that creditors are informed. After such notice is published, the creditors have two months to notify the liquidators of all their claims against the non-profit association. Even when they do not do this the money belonging to the known creditors must be deposited in escrow for them. The remaining assets are distributed among persons entitled to them by the Articles of Association or to the persons designated by the general assembly (NPAA, Article 50). If the Articles of Association do not state or the general assembly does not prescribe among whom the assets should be distributed and the association was founded only in the interests of its members, the assets have to be distributed in equal parts to the members. It should be mentioned that to obtain tax exemption, one requirement is that the Articles of Association may not permit the distribution of assets upon liquidation to the members of the non-profit association. See below under Part VIII, Section 4(1).

B. Involuntary Dissolution

The conditions for involuntary or compulsory dissolution of non-profit associations and foundations are prescribed in Article 40 of the NPAA and in Article 46 of the FA. Using associations as an example, Article 40 of the NPAA provides that non-profit associations can be dissolved by a court order at the request of the Minister of Interior or other interested persons. Compulsory dissolution can take place if the objectives or activities of the non-profit associations are contrary to law, the constitutional order or good morals, the activities do not comply with the objectives in the Articles of Association, economic activity becomes the main activity of the non-profit association, or the management board does not submit an application for dissolution provided by law (in the case of bankruptcy) (NPAA Article 40).

The procedures for compulsory dissolution are generally the same as in the case of voluntary liquidation. The main difference is that the liquidator is appointed by a court order and the assets remaining after compulsory dissolution are transferred to the state on the basis that its objectives or activities were contrary to criminal law, constitutional order or good morals (NPAA, Article 50). As with every other court decision, a decision for compulsory dissolution is appealable.

The procedures for involuntary dissolution of foundations are essentially the same as those for associations. (FA, Articles 46-58)

V. REGULATIONS

A foundation must file annual accounting statements where non-profit associations and foundations register. If they fail to do this, the courts have the right to impose a fine of up to 400 daily salaries or approximately $1000 US.

VI. FOREIGN ORGANIZATIONS

There are no special rules for activities of foreign organizations. Estonia generally confers legal personality on foreign juridical entities. Foreign organizations can establish a NPO or a representative office.

VII. MISCELLANEOUS

A. Mergers and Split-Ups

The rules for mergers and split-ups are provided in Articles 56-74 of the NPAA and Articles 61-79 of the FA. In the case of foundations, the possibility for a merger or division is limited to the cases prescribed in the Articles of Association. Mergers and divisions of non-profit associations depend upon a decision of their members.

Generally the rules for a merger or division of a non-profit association demand a separate merger or division agreement by the management board, an approval (or merger or division resolution) by the supreme body of the organization, publication of two notices concerning a merger or division within at least a 15 day interval in a national newspaper calling on creditors to submit their claims, the securing or satisfying of the claims of creditors by the management board, and finally, entering the merger or division into the register.

B. Dealings in Property

There are no special rules for dealings in property by NPOs in Estonia. They simply must conform with the general laws dealing with property (i.e. Civil Code, Property Act etc.).

C. Investment Abroad

There are no restrictions preventing NPOs registered in Estonia from making investments abroad.

D. Political Activities

Political activities are not clearly defined in Estonian laws. However, only officially registered political parties have the right to put up candidates for local and general elections. (The Act on Political Parties adopted in 1994, needs to be amended.) There are no restrictions against NPOs lobbying for legislation. The co-operation between authorities and NPOs in this area is remarkable, partly because of the small size of country. Politicians are interested in cooperating with third sector organizations because it provides them with organized and structured contacts with the electorate.

VIII. TAX LAWS

A. Tax Exemptions

1. Income Tax

Estonian legislation divides all NPOs into two groups for taxation purposes: (1) NPOs created for the mutual benefit of their founders and members; and (2) NPOs created for the public benefit.

The Estonian Income Tax Act grants all non-profit associations and foundations tax exemption on entrance and membership fees as well as on interest paid by Estonian financial institutions. In the case of donations, only NPOs listed by the government have the right to tax exemption. This list is approved by the local tax authorities and Ministry of Finance. Only NPOs acting for public benefit in the fields of education, culture, science, environment, health, sports, social welfare, and religion are permitted to be placed on the list. The list is reviewed annually and consists of approximately 1000-1500 NPOs.

2. Value Added Tax (VAT)

NPOs are granted tax exemption on import VAT if the goods are irrecoverable foreign aid, and if they are purchased for the money received as irrecoverable foreign aid. In these cases, the prepaid VAT will be refunded. Additionally, churches and religious organizations have VAT exemption on the electricity they consume.

B. Deductibility of Donations

The sponsors have the right to tax deductions if they donate to NPOs listed on the government list. The amount of income tax exemption will not exceed 10% of their profits. Although there is no limitation on contributions, the amount of contributions in excess of 10% of the annual profits will be nondeductible.

C. Related and Unrelated Business Activities

There are no restrictions placed on the business activities of NPOs so long as these activities do not become the main activities. See above under Part II, Section F. However, all income from business activities is taxable on equal footing with the income of business associations.

D. Reporting

All NPOs must keep their books and records in accordance with the requirements of the Accounting Act. In the case of foundations the annual accounts and activities report must be audited by a professional auditor. (FA, Articles 34-36) Annual accounts and activities reports must be approved by the general assembly of the non-profit association or by the supervisory board of a foundation. A copy of the approved report must be submitted to the Register of Non-Profit Associations and Foundations.

IX. COMPLIANCE

Non-compliance is not a widespread problem in Estonia, although this potential was discussed during the preparation phase of the new legislation. Generally there has not been a practice of using NPOs as tax dodges. These problems may arise in future, but for now, the biggest problem with respect to compliance is the lack of accounting experience and knowledge.

X. GOVERNMENT FUNDING

The Estonian State helps fund the non-profit sector through tax revenues. For example, organizations promoting folk culture, arts, physical fitness, and sport receive their funding from the Cultural Endowment of Estonia. Proceeds supporting these organizations come from the excise tax on alcoholic beverages and tobacco products, as well as from gambling taxes obtained pursuant to the Alcohol Excise Act, the Tobacco Excise Act, and the Gambling Tax Act. The total sum from these sources in 1998 amounted to approximately 80,000,000 EEK ($5,000,000 US) which was nearly 0.5% of the total amount of revenues in the state budget. Additionally, many public benefit NPOs receive direct funding from the state budget. The total sum of this type of state funding exceeded, in 1998, 100,000,000 EEK ($7,000,000 US).

XI. PROPOSED LEGISLATION

The new Government (formed after the elections in March 1999) is currently preparing amendments to the tax laws. In December 1999, the new Income Tax Act was passed and is in force starting January 1, 2000. The main goal for Parliament, however, was to create an improved system for creating a list of public benefit NPOs. Ideas for creating the list included receiving applications from NPOs wishing to be placed on the list; separating first year applicants from public benefit NPOs with a longer history and more experience; and including representatives of NPOs in the selection process. This list was produced in summer of 1999, which resulted in an enactment of a regulation that contains a list of NPOs with public benefit status. Finally, the new Obligation Act is in its final stages of drafting, which will help solve problems regarding non-profit partnerships.

In spring 2000, the Estonian Parliament will discuss cooperation agreements between the third sector and state and local governments.

XII. CONCLUSIONS

The development of legal thought and understanding of the problems and the importance of the third sector in Estonia has been quite rapid. Of special importance was the enactment of two basic liberal laws in 1995 and 1996: the Foundation Act and the Non-Profit Associations Act, which laid the foundation for activities of NPOs in Estonia. Today, in light of the developing tax legislation, it is hoped that the Estonian third sector will soon have one of the most modern and clear, transparent systems in the region.