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Use of Estonia in U.S. International Tax Planning

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According to recent estimates, Estonia, which is situated halfway between Stockholm and St. Petersburg, currently has more than 350 start-up technology companies – one for every 3,700 citizens – and the government expects this number to reach 1,000 by the year 2020. This makes Estonia the number one start-up technology country in Europe and one of the top in the world. The most recognizable technology company with Estonian roots is Skype, which was acquired by Microsoft in 2011 for $8.5 billion.

There are a number of reasons why a country as small as Estonia is producing this many technology companies, including a stable economic environment (i.e., Estonia's economic freedom is regarded as one of the highest in the world and the best in the Central and Eastern European (CEE) region); the population of Estonia has the highest average level of education in the CEE region; and the country is supported by a tech-savvy government (an example of this is Estonia's "e-residency" program, which allows non-residents to establish local businesses and bank accounts, and operate them remotely after only a single visit to Estonia).

Another significant advantage offered to companies doing business in Estonia is its unique corporate income tax system. Estonia is the only country in the EU where corporate profits are not subject to current income tax. Instead a corporate income tax is imposed only upon the payment of a dividend to the company's shareholders (and upon payments deemed equivalent to dividends, such as certain gifts and donations, fringe benefits to employees, etc.) This allows companies to defer paying corporate income tax indefinitely so long as the profits are retained or reinvested. Once a dividend payment is made, a flat corporate income tax will be imposed at the rate of 21/79, which is equal to 21 percent of gross profit (or an effective tax rate of approximately 26.6 percent).

It is important to note that, while the corporate income tax is triggered upon the payment of a dividend, the tax is imposed on the corporation itself, not the shareholder. Therefore, it cannot be reduced pursuant to the EU parent-subsidiary directive or an income tax treaty that Estonia is a party to (although the corporate income tax can be reduced by any income tax withheld on payments received by an Estonian entity). Profits can, however, be repatriated without triggering corporate income tax if the amounts are paid in the form of interest, royalties or other types of payments, so long as they are not actual or deemed dividends. Profits also may be loaned to third parties or within corporate groups without triggering corporate income tax, which allows for tax efficient opportunities for intra-group finance activities.

Other notable tax benefits available in Estonia include the lack of thin capitalization rules (i.e., no debt to equity requirements); no withholding tax on interest[1] or dividends to non-residents (or on royalties paid to EU residents or Switzerland); and a wide network of income tax treaties with countries around the world. As discussed below, these tax benefits provide for a number of interesting tax planning opportunities in both the outbound and inbound U.S. tax context.[2]

Use in Outbound U.S. Tax Planning

Income earned through a U.S.-controlled foreign corporation typically will not be subject to U.S. federal income tax until such time as its profits are repatriated to the United States in the form of a dividend. An important exception to this rule exists for income classified as "subpart F" income under the controlled foreign corporation (CFC) rules.

Pursuant to Estonia's corporate income tax system, profits earned by a CFC in Estonia that are not characterized as subpart F income will not be subject to tax in Estonia or the United States until such time as those profits are repatriated to the United States in the form of a dividend. Therefore, such income can be deferred from tax indefinitely. While admittedly there are other jurisdictions around the world (e.g., the Cayman Islands, Bahamas, the UAE, etc.) that have no corporate income tax, none of those jurisdictions are parties to as many (or in most cases, to any at all), comprehensive income tax treaties as Estonia. Currently, Estonia has 56 income tax treaties in force, including those with low-tax countries such as the UAE, Jersey, and Singapore.

Therefore, an Estonian CFC can receive royalties from the license of intellectual property or interest on loans from other treaty jurisdictions and obtain reduced rates of withholding tax, without such income being subject to current income tax in Estonia (or the United States, assuming the income is not characterized as subpart F income because, for example, it is received from a disregarded entity or the income qualifies for an exception to subpart F income, such as the active royalty exception). In addition, income derived from the performance of services in Estonia also would be completely exempt from current corporate income tax in Estonia and the United States, even if such services were performed for related parties. Finally, like many other European jurisdictions, Estonia has a favorable holding company regime that permanently exempts most dividends[3] and capital gains from corporate income tax.

As a result, the primary tax benefits that many U.S. multinationals typically seek to achieve, namely – the deferral of foreign profits from U.S. tax and little, if any, foreign income tax – with common structures, such as the "Double Irish Dutch Sandwich" structure, can in effect be replicated by using a single Estonian entity, so long as the profits are retained or reinvested. Based on recent reports, which indicate that U.S. multinational corporations' offshore cash holdings nearly doubled between 2008 and 2013 to more than $2.1 trillion, retaining or reinvesting these offshore profits would seem to be the desired result.

It is also interesting to note that because the United States has a comprehensive income tax treaty with Estonia (the "Treaty"), two other potential planning opportunities may be available in the outbound context. For one, assuming the Estonian CFC is owned by individuals (or a pass-through entity owned by individuals) any dividends that are eventually paid to the CFC's U.S. shareholders will be eligible for qualified dividend rates of 20 percent (plus the 3.8 percent Medicare tax). Again, this benefit generally would not be available for profits that were being accumulated tax free in a low-tax jurisdiction, such as the Cayman Islands or the UAE, given that the United States does not have comprehensive income tax treaties with these jurisdictions.

Second, it appears that Section 457A could be avoided by using an Estonian entity, even though no earnings are subject to current foreign income tax. In general, Section 457A provides that compensation which is deferred under a non-qualified deferred compensation plan of a "nonqualified entity" is includible in gross income when there is no substantial risk of forfeiture of the rights to such compensation. For this purpose, the term "nonqualified entity" means any foreign corporation unless substantially all of its income is subject to a comprehensive foreign income tax.

Substantially all of the income of a foreign corporation will be treated as being subject to a comprehensive foreign income tax if:

1. Either (A) the foreign corporation is eligible for the benefits of a comprehensive

income tax treaty between its country of residence and the United States, or (B) the foreign corporation demonstrates to the satisfaction of the Secretary that it is resident for tax purposes in a foreign country that has a comprehensive income tax; and.

2. The foreign corporation is not taxed by the foreign corporation's country of residence under any regime or arrangement that is materially more favorable than the corporate income tax otherwise generally imposed by such country.[4]

Unlike Irish Section 110 companies or Luxembourg securitization vehicles, assuming an Estonian corporation is resident in Estonia for purposes of the Treaty and the Treaty's limitation on benefits (LOB) provision is satisfied, these tests would seem to be met because such corporation would not be taxed in Estonia under any regime or arrangement that is materially more favorable than the corporate income tax generally imposed by such country.

Use in Inbound U.S. Tax Planning

As noted above, the United States has a comprehensive income tax treaty with Estonia that contains an LOB provision. Therefore, assuming an Estonian company qualifies for treaty benefits (e.g., either because it is owned by residents of Estonia or it has an active trade or business Estonia), reduced U.S. withholding tax rates would be available for dividends (a 5 percent rate would apply rather than a 30 percent rate), interest (a 10 percent rate would apply rather than 30 percent), and royalties (either 10 or 15 percent rather than 30 percent). Consequently, in addition to reduced rates of U.S. withholding tax, no current corporate income tax would be imposed on these payments in Estonia.[5] In addition, any U.S. withholding taxes that are imposed can be used to reduce the ultimate corporate income tax due when a dividend is paid out of Estonia.

Access to the favorable Estonian income tax regime also is available in inbound structures even if it is not possible to qualify for benefits under the Treaty. This can be achieved by using an Estonian branch (or "permanent establishment") of a non-Estonian corporation because branches enjoy the same tax benefits as Estonian corporations, i.e., no current income tax until the profits are remitted to the home office.

Estonia has several income tax treaties with other jurisdictions (some of whose treaties with the United States currently contain no LOB provision) under which any income allocated to an Estonian branch or "permanent establishment" would be exempt from tax in the home country. For example, assume that residents from a jurisdiction that do not have an income tax treaty with the United States (e.g., UAE) wish to finance a real estate project in the United States by using debt. The investors also would like to share in the profits from the sale of the real estate by receiving an "equity kicker" in the form of contingent interest. The non-U.S. residents could establish a company in either Poland or Hungary with an Estonian branch. The loan would be made from the Estonian branch to the United States. Under the U.S. income tax treaties with Poland and Hungary, no U.S. withholding tax would be imposed on the interest (including the contingent interest) paid from the United States to the Estonian branch. No current income tax would be imposed in

Estonia until such time as the income is remitted back to its home office. Furthermore, under the Estonian treaties with Hungary and Poland, any income allocated to a branch in Estonia will be exempt from tax in Hungary and Poland. Therefore, this structure would result in tax-free payments of deductible interest in the United States, and no current foreign income tax. Similar tax benefits could be obtained when licensing intellectual property to the United States if the licensing is done by an Estonian branch of a Hungarian company.

The benefits of using a branch in Estonia for this purpose, as opposed to a Swiss finance branch (which is commonly used) are that:

1. The tax regime in Estonia is not currently scheduled to sunset (unlike the Swiss finance branch rules, which are currently scheduled to expire in 2018) and,
2. the Swiss finance branch rules only apply if the balance sheet total of the branch is at least 100 million Swiss francs, whereas there is no minimum balance sheet total needed in Estonia to gain access to these benefits.

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1 Payments of interest will be subject to withholding tax (eligible for treaty reduction), only if the interest payments are substantially in excess of market rates.

2 Other tax advantages of using Estonia in cross-border structures include (i) Estonia not being treated as a tax haven or a blacklisted country in any regime that the author is aware of, and (ii) that the BEPS initiative should not treat the Estonian tax system as a harmful preferential tax regime.

3 Only dividends from low-tax jurisdictions do not qualify for the exemption.

4 Notice 2009-8, Q-8, IRB 2009-4.

5 The dividend may be exempt from tax permanently under Estonia’s participation exemption.