

Under Estonian CIT, renting from a shareholder generates hidden profits

I. Tax authorities strict on regulations on hidden profits

The tax authorities are increasingly presenting a very strict position when interpreting hidden profits taxed with Estonian CIT. A good example of this are two individual tax interpretations issued by a National Tax Information Director. The one issued on 4 November 2022 (number 0111-KDIB1-1.4010.497.2022.2.AND) pertains to a property rental that was deemed to constitute a hidden profit. Similarly, in the interpretation of 30 November 2022 (number 0111-KDIB1-2.4010.474.2022.2.DP) on equipment rentals, the rental was found to constitute a hidden profit. To recap, the concept of such profits was introduced by the regulations on flat-rate taxation of corporate income (so-called Estonian CIT).

II. Not all income can be taxed with Estonian CIT

In accordance with currently binding CIT regulations, flat-rate taxation is generally applied to income that corresponds to: that portion of the amount of net profit generated in the period of flat-rate taxation which was by resolution designated to be paid out to shareholders or partners (income from distributed profit) or to cover losses from the period preceding the period of flat-rate taxation (income from profit designated to cover losses); the amount of hidden profits (income from hidden profits); the amount of expenses not related to business activities (income from non-business expenses); the excess of the market value of assets acquired or contributed in kind over the tax value of those assets (income from a change in the value of assets) - when entities are merged, split, transformed or an in-kind contribution made of a business or its organized part; the total net profits generated in each tax year of flat-rate taxation insofar as those profits were not distributed or designated to cover a loss (income from net profit) - for taxable persons who no longer apply flat-rate taxation; the value of revenue and costs that in accordance with accounting regulations are to be recognized in the tax year and included in the net profit (loss), but have not been included in that net profit (loss) (income from undisclosed business operations).

A reasonably acting business entity strives to equip the company with the assets necessary to run the business, rather than generating additional costs of having to rent the assets necessary to run the business – is the position presented by the tax authorities, which have consistently classified the fees paid by companies to rent equipment and real properties from their shareholders as hidden profits.



III. Regulations with a broad definition of hidden profits

Hidden profits are defined as cash, non-cash, chargeable, non-chargeable or partially chargeable benefits performed in connection with a right to share in profits, other than distributed profits, where the direct or indirect beneficiary is a shareholder or partner or a direct or indirect related party of the taxable person or that shareholder or partner, and in particular: a loan (credit) granted by the taxable person to a shareholder or partner, also through funds formed from profits, or to a related party of the shareholder or partner, as well as interest, commissions, fees and charges on a loan (credit) granted by those entities to the taxable person; benefits provided to a private or family foundation, entity equivalent to such a foundation or business operated by such a foundation or entity, or for the beneficiaries of such a foundation or entity, as well as for a trust or another entity or legal relationship of a fiduciary nature; the excess of the market value of a transaction determined in accordance with transfer pricing regulations over the agreed price of the transaction; the excess of the returned amount of a contribution made to the company in accordance with separate regulations over the contributed amount, where if the contribution was made in a foreign currency, the amount is translated into PLN using the average exchange rate announced by the National Bank of Poland as at the contribution return date and the actual contribution date, respectively; remuneration paid from profit for the redemption of a share, reduction in the value of a share, withdrawal of a partner from the company, reduction of a partner's equity interest in the company; the equivalent of the profit designated to raise the company's share capital; donations, including all types of gifts and offerings; representation expenses; contributions made during company merger or split; interest paid by the company on a partner's equity interest; profit designated to replenish the equity interest of the company's partner; cash and non-cash benefits paid out when the equity interest of the company's partner is reduced.

IV. Tax authorities see renting of real properties from shareholders as a hidden profit

Based on the above regulations, in the first of the mentioned interpretations (of 4 November 2022) the tax authority found that the fact that the company does not own any assets necessary to run a shipping and transport business, and as a result rents an office, warehouse, garage with shop and a yard that is part of its operating base from one of its shareholders, leads to the conclusion that the company's shareholder did not equip the company with the assets necessary to run the business. In consequence, the tax authority found that the benefit related to renting assets from a shareholder constitutes a hidden profit within the meaning of CIT regulations. It also stressed that in this case, the fact that the transaction is concluded on market terms does not mean that other conditions that make it possible to classify this benefit as a hidden profit have not been met.



V. Renting of equipment from company shareholder a hidden profit too

In the second interpretation (of 30 November 2022), the tax authority found that a reasonable business strives to equip the company with the assets necessary to run the business rather than generating additional costs of renting such assets. Had the shareholder sold or contributed the equipment and vehicles to the company, he would not be getting remunerated for renting those assets. In such situations, the fee for the rental of the said assets by the company's shareholders will constitute a hidden profit. The fact that the company does not have all of the assets necessary to run the business and intends to rent them from its shareholders leads to the conclusion that the company's shareholders did not equip the company with the assets necessary to run the business. In consequence, this must be interpreted as recapitalization of related parties.



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VI. Shareholders required to equip company with necessary assets

Both interpretations stress that evaluating whether a transaction could be concluded between the company and its shareholder should not be limited to only assessing the agreed transaction price (at arm's length), but should also consider whether the given transaction would be concluded at all. In making this assessment one should consider the company's needs from the perspective of its areas of activity, the reasonableness of purchasing or performing the transaction in the context of the company's financial position or its actual business needs. It may be significant to the company-shareholder relationship whether the shareholder has taken care to equip the company with the assets necessary to run the business, and whether any shortage of such assets is the reason for actions consisting of the resulting recapitalization of the company, i.e. recapitalization in a form other than a contribution (e.g. in the form of a loan, provision of a property). This is because dividend-equivalent benefits, i.e. benefits that under the guise of a differently named act in law (one or more) de facto lead to a gain for the shareholder that would otherwise be paid out as a dividend, also create income from hidden profits.

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